

No. 89-

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IN THE  
**Supreme Court of the United States**  
October Term, 1989

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INVESTMENT COMPANY INSTITUTE,  
*Petitioner,*

v.

SECURITIES AND EXCHANGE COMMISSION,  
*Respondent.*

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**CONDITIONAL PETITION  
FOR A WRIT OF CERTIORARI  
TO THE UNITED STATES COURT OF APPEALS  
FOR THE SEVENTH CIRCUIT**

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## QUESTION PRESENTED

In the event that stock-index participations ("IPs") are not "contracts \* \* \* for future delivery" within the meaning of the Commodity Exchange Act subject to the exclusive jurisdiction of the Commodity Futures Trading Commission but are "securities" within the meaning of the federal securities laws subject to the jurisdiction of the Securities and Exchange Commission, do IP programs also involve the creation and operation of "investment companies" within the meaning of, and subject to the requirements of, the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1, *et seq.* (1981 & Supp. 1989).

## PARTIES TO THE PROCEEDING

In addition to the parties identified in the caption, the following were parties to consolidated proceedings in the Court of Appeals: the Chicago Mercantile Exchange and the Board of Trade of the City of Chicago were petitioners and the American Stock Exchange, Inc., the Chicago Board Option Exchange, Inc., the Philadelphia Stock Exchange, Inc. and the Options Clearing Corporation were intervenor-respondents. The Commodity Futures Trading Commission appeared as *amicus curiae* in support of the Chicago Mercantile Exchange and the Board of Trade of the City of Chicago.<sup>1</sup>

<sup>1</sup> Pursuant to Rule 29.1 of this Court, petitioner Investment Company Institute states that it is the national association of the investment company industry. The Institute's membership includes approximately 2,961 open-end investment companies (commonly known as "mutual funds"), 177 closed-end investment companies and 13 sponsors of unit investment trusts. The Institute's mutual fund members have assets of about \$932 billion, accounting for over 90% of total industry assets, and have over 30 million shareholders. The Institute's membership also includes the investment advisers and principal underwriters for its investment company members.

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After consolidated briefing, argument and decision, the United States Court of Appeals for the Seventh Circuit entered a single judgment adjudicating three consolidated Petitions for Review — Nos. 89-1763, 89-1786 and 89-2012 — which challenged two Orders issued by the Securities and Exchange Commission (the “SEC” or “Commission”). The single judgment invalidated the SEC Orders pursuant to the Petitions for Review filed by the Chicago Mercantile Exchange and the Board of Trade of the City of Chicago (Nos. 89-1763 and 89-1786) and accordingly dismissed as moot the Petition for Review filed by the Investment Company Institute (No. 89-2012).

The American Stock Exchange, Inc. (“AMEX”), the Philadelphia Stock Exchange, Inc. (“PHLX”), the Chicago Board Options Exchange, Inc. (“CBOE”) and the Options Clearing Corporation (“OCC”) have petitioned for Writs of Certiorari to review that portion of the single judgment which adjudicated Nos. 89-1763 and 89-1786 of the consolidated

proceedings below and which invalidated the SEC Orders. In the event this Court grants any of these petitions, petitioner Investment Company Institute (the "Institute") respectfully prays that a Writ of Certiorari also issue with respect to the remaining portion of the single judgment which adjudicated No. 89-2012 of the consolidated proceedings below and which dismissed the case as moot in light of the disposition in Nos. 89-1763 and 89-1786.<sup>1</sup>

### OPINIONS BELOW

The opinion issued by the United States Court of Appeals for the Seventh Circuit (1c-25c)<sup>2</sup> in the consolidated proceedings is reported at 883 F.2d 537 (7th Cir. 1989). The single judgment entered by the Court of Appeals (1b-2b) in the consolidated proceedings is unreported. The Court of Appeals' order (1d-5d) consolidating the Institute's Petition for Review with the Petitions for Review filed by the Chicago Mercantile Exchange ("CME") and the Chicago Board of Trade ("CBOT") is unreported. The Court of Appeals' opinion denying rehearing and rehearing *en banc* (1a-4a) in the consolidated proceedings is reported at 883 F.2d 537, 550 (7th Cir. 1989). The two administrative orders (1f-52f, 1g-22g) of the SEC under review are set forth at 54 Fed. Reg. 15,280 (1989) and 54 Fed. Reg. 15,575 (1989).

<sup>1</sup> As of the filing of this Conditional Petition, it is unclear whether a Petition for a Writ of Certiorari will be filed on behalf of the SEC in this Court. In the event such a petition is filed and granted, the Court should grant this Conditional Petition as well for all the same reasons that the Court should grant this Conditional Petition in the event the Court grants the Petitions for Writs of Certiorari filed by the AMEX, the PHLX, the CBOE and the OCC.

<sup>2</sup> Materials reproduced in Appendices A-H annexed to this Petition are cited to the pages of the numbered Appendices. Thus, citations to materials reproduced in Appendix A appear as (\_\_\_ a), citations to materials reproduced in Appendix B appear as (\_\_\_ b), and so on.

### JURISDICTION

The judgment of the United States Court of Appeals for the Seventh Circuit was entered on August 18, 1989. The Court of Appeals denied Petitions for Rehearing and Rehearing *en banc* on October 23, 1989. On January 12, and 17, 1990, Justice Stevens granted the United States, the AMEX, the PHLX, the CBOE and the OCC extensions of time until March 22, 1990 to file petitions for Writs of Certiorari. On January 19, 1990, Justice Stevens granted the Institute an extension of time until March 22, 1990 to file a petition for a Writ of Certiorari. The Court's jurisdiction is invoked under 28 U.S.C. § 1254(1) (Supp. 1989).

### STATUTE INVOLVED

Involved in this action are several provisions of the Investment Company Act of 1940 (the "Act"). Section 3(a) of the Act defines the term "investment company" to include, among other things, any "issuer" that is "engaged primarily \* \* \* in the business of investing, reinvesting, or trading in securities." 15 U.S.C. § 80a-3(a) (1981). Section 2(a) of the Act in turn defines the term "issuer" to mean "every person who issues or proposes to issue any security." *Id.* § 80a-2(a)(22) (1981). Section 2(a) of the Act defines the term "person" to mean "a natural person or a company," and also defines the term "company" to include "a corporation \* \* \* a trust, a fund, or any organized group of persons whether incorporated or not." *Id.* §§ 80a-2(a)(8), (28) (1981).

### STATEMENT OF THE CASE

#### A. Background

The consolidated proceedings below arose out of two Orders issued by the SEC on April 11, 1989. One of these Orders approved proposed rule changes which had been sub-



mitted by the AMEX, the PHLX and the CBOE (collectively referred to as the "Exchanges") in order to trade instruments generically known as "index participations" ("IPs") (the "Exchange Order") (1f-52f). The other Order approved rule changes which had been submitted by the OCC in order to issue, clear and settle IPs (the "OCC Order") (1g-22g).

In approving the proposed rule changes, the Commission specifically recognized that the IP programs involve, in economic substance, the creation and operation of investment companies (commonly known as "mutual funds"). Thus, the Commission admitted that IPs, like investment companies, are vehicles designed to provide investors with "a present interest in the current value of a portfolio of stock" (2f). Indeed, SEC Commissioner Cox declared that, "if you go down the characteristics of these products, \* \* \* these index participation products seem most like a type of mutual fund, an index fund" (3h). "I really think we have something closest here to an index fund for investors" (*id.*).

Notwithstanding these admissions, and despite the Commission's concession that application of the federal securities laws turns on the economic realities and economic substance of the underlying transaction, the SEC declared that the Investment Company Act, the comprehensive statutory framework Congress enacted to protect investors in investment companies, does not apply to IP programs. It is the Commission's narrow and grudging misconstruction of the Investment Company Act, in contravention of longstanding judicial and administrative authority dictating application of the Act in the circumstances presented, that forms the basis for the Institute's challenge to the SEC Orders.

## B. The Investment Company Business

An investment company is a vehicle that provides investors with an interest in a portfolio of stocks or other securities.<sup>3</sup> It does so by issuing to the public securities that represent a proportional, undivided interest in the stocks or other securities held in the investment company's portfolio. Investment company securities thus entitle an investor to receive a proportional share of both the capital gains and losses generated by, and the dividends and interest paid by issuers of, the securities held in the investment company's portfolio. Securities issued by investment companies organized as corporations are known as "stock" or "shares," and securities issued by companies organized in non-corporate forms generally are designated as "units of participation," "units of beneficial interest," "participating agreements," or the like.

Open-end investment companies, commonly known as mutual funds,<sup>4</sup> issue "redeemable securities" which entitle the holder, upon presentation to the investment company or its agent, to receive approximately the holder's proportionate share of the investment company's current net assets or the cash equivalent thereof. 15 U.S.C. §§ 80a-2(a)(32), 80a-5(a)(1) (1981 & Supp. 1989). Largely because holders of mutual fund securities may thus always sell their shares back to the investment company for cash, there is generally no significant secondary market for mutual fund shares.

Closed-end investment companies on the other hand do not issue redeemable securities. *Id.* § 80a-5(a)(2) (Supp. 1989).

<sup>3</sup> The following description of the investment company business is drawn from the opinions in *Investment Company Institute v. Camp*, 274 F. Supp. 624, 628-30 (D.D.C. 1967), *rev'd sub nom. Comptroller of the Currency v. Investment Company Institute*, 420 F.2d 83 (D.C. Cir. 1969), *rev'd*, 401 U.S. 617 (1971) and *Board of Governors of the Federal Reserve System v. Investment Company Institute*, 450 U.S. 46 (1981) ("Board of Governors"). See also *United States v. Cartwright*, 411 U.S. 546 (1973); *The Mutual Fund Industry: A Legal Survey*, 44 Notre Dame Law. 732 (1969).

<sup>4</sup> *Investment Company Institute v. Camp*, 401 U.S. 617, 625 n.11 (1971).

Section 23(c) of the Investment Company Act limits the circumstances under which a closed-end investment company may repurchase securities that it has issued to purchases made on a securities exchange after statutorily prescribed notice has been provided to security holders, purchases made pursuant to tender offers, and purchases made pursuant to a rule, regulation or order of the SEC. 15 U.S.C. § 80a-23(c) (1981). Because closed-end investment company shares are not freely redeemable, an investor that desires to liquidate his holdings generally must sell the shares in the secondary market which develops for those securities.<sup>5</sup>

Management investment companies typically are organized and sponsored by a securities firm known as an investment adviser. *Board of Governors*, 450 U.S. at 50. Once the investment company has been created, the adviser generally enters into a contractual arrangement with the company whereby the adviser agrees to provide the company with investment advice concerning the management and makeup of the company's portfolio, in addition to various management and administrative services. The investment adviser typically uses the proceeds from the sale of the investment company's securities to investors to purchase additional securities for the company's portfolio. The investment adviser selects securities for the portfolio that the adviser determines will accomplish the company's stated investment objectives, and may, within the confines of the investment objectives stated in the investment company's registration statement, see 15 U.S.C. § 80a-8(b), change the content of the company's investment portfolio.

<sup>5</sup> Under the Investment Company Act, a "closed-end" investment company which purports to issue securities redeemable under conditions other than those specified in Section 23(c) is deemed to be an "open-end" company, with the result that the securities issued by that company are in fact freely redeemable upon presentation. See *Dimensional Fund Advisors Inc.*, SEC No-Action Letter [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,913, at 78,579 (Nov. 21, 1988).

Although the investment adviser typically initially organizes an investment company, thereafter the Investment Company Act requires that a managed investment company operate under the exclusive authority of a Board of Directors.<sup>6</sup> "[T]he structure and purpose of the [Investment Company Act] indicate that Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interests of the [company] shareholders." *Burks*, 441 U.S. at 484-85 (footnote omitted).<sup>7</sup>

One popular type of investment company, commonly known as an "index fund," is designed specifically to offer investors a return that corresponds to the composite price and dividend performance of a designated index of stocks. An index fund achieves this goal by holding a portfolio of common stocks designed to replicate the performance of the stocks contained in the designated index. Because the securities in an index investment company's portfolio are selected in order to mimic the performance of a designated stock index, the role of the investment adviser to an index fund generally is limited to selecting, and executing transactions in, securities that replicate the underlying index.

### C. The Stock-Index Participation Programs Operated By The Exchanges And The OCC

Like conventional investment companies, the IP programs sponsored and operated by the Exchanges and the

<sup>6</sup> See, e.g., *Burks v. Lasker*, 441 U.S. 471 (1979) ("*Burks*"). Investment company directors are "'independent watchdogs' . . . who would 'furnish an independent check upon the management' of investment companies." *Burks*, 441 U.S. at 484 (quoting *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (2d Cir. 1977); Hearings on H.R. 10065 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 109 (1940)).

<sup>7</sup> Securities issued by management investment companies, whether open-end or closed-end, typically are distributed to the investing public through a securities firm known as a principal underwriter, which usually is the investment adviser itself or an affiliate of the investment adviser, and then by securities brokers and dealers.



OCC constitute vehicles for providing investors with "a present interest in the current value of a portfolio of stock" (2f). They do so by having the OCC issue securities, called "long" IPs, that entitle the holder to receive payments representing the capital appreciation and dividends attributable to the stocks comprising a stock index designated by the Exchange (6f-8f, 24f). Holders of long IPs are thus entitled to receive from the OCC "capital gains or losses [ ] directly related to the gains or losses from the portfolio's stocks" (24f) in addition to a proportionate share of the dividends declared by the companies comprising the index (3c, 2f).

An investor seeking to sell his IP interest may do so by redeeming or "cashing-out" the security with the OCC at certain times permitted by the Exchanges. An investor holding an AMEX IP or a PHLX IP may exercise his right to redeem or cash out his interest on a quarterly basis (4c, 2f) and an investor may cash out a CBOE IP semi-annually (4c-5c, 4f). The PHLX also permits IP holders to redeem their IPs on a day other than the quarterly cash-out date, but only upon payment of a 0.5 percent fee (4c, 2f-3f).<sup>8</sup>

In keeping with the rules of the Exchanges, the OCC uses the proceeds received from the continuous sale of IP "longs" to invest in securities in the form of IP "shorts" based upon the same underlying indices. Holders of shorts are obligated to pay to the OCC any capital gains attributable to the securities underlying the index, and are obligated to pay to the OCC a proportion of any dividends declared by the issuers of the securities underlying the index (4c, 27f, 3g). When dividend payments are due to the holder of an IP long

<sup>8</sup> The OCC does not issue IPs directly to, and in the name of, the purchasing investors, but to and in the name of a broker that is a clearing member of the OCC (5f, 6g). When buying an IP, therefore, the money paid by an investor flows from the investor to his broker to the clearing member to the OCC. When an IP holder receives dividend payments or redemption payments upon cash-out, the money paid to the investor flows from the OCC to the clearing member to the broker to the investor (9g). Where the investor's broker also is a clearing member, there is one less link in this chain.

or when the holder of a long redeems his securities by exercising the cash-out privilege, the OCC randomly selects and assigns the long IP to one of the outstanding IP shorts for payment (4c, 6g-7g).<sup>9</sup>

The Exchanges and the OCC together manage the operation of the IP programs. Each Exchange selects the indices upon which to trade IPs and selects the individual securities to be included in certain IP index portfolios.<sup>10</sup> The Exchanges may, in their sole discretion, change the content of the index portfolios underlying the IPs (6f-8f). The Exchanges and OCC also may postpone payments of dividend equivalents or redemptions (7g n.18), and may even liquidate all outstanding positions under specified circumstances (6f, 18g-19g). The Exchanges, in addition, may limit the number of IPs an investor may buy or redeem at any given time (48f), and the OCC may adjust outstanding positions due to changes to the underlying index made by the Exchanges. The OCC also will perform designated recordkeeping and accounting functions for the IP programs (16g).

#### D. The SEC Proceedings and Orders

Between March 23, 1988 and March 20, 1989, the Exchanges and the OCC filed with the Commission applications and numerous amendments thereto seeking Commission ap-

<sup>9</sup> The OCC's rules do not permit the OCC to issue a long IP unless and until it has received a report from an Exchange indicating that an investor exists who will take a short IP position. In the context of short IPs, the OCC again does not pay the money received from IP longs directly to IP shorts, but instead the money flows from the OCC to a clearing member of the OCC to the broker for the short and then to the short (16c). Dividend and redemption payments from IP shorts also flow from the short to his broker to the clearing member to the OCC (7g). Again, where the broker for the short is also a clearing member for the OCC, there is one less link in this chain. See OCC Rule 502(b), *reprinted in American Stock Exchange Guide* (CCH) ¶ 14,082, at 4217-5 (1987).

<sup>10</sup> Each Exchange proposed to trade IPs based upon at least one standardized Standard & Poors ("S&P") index—the S&P 500 (6f-8f). Each Exchange also proposed to list and trade at least one IP based upon a proprietary stock index selected and compiled by the Exchange or its agent (*id.*).

proval of rule changes required to implement the IP programs (1f, 1g-2g). Numerous comment letters were submitted to the SEC concerning the various applications and amendments, including comment letters submitted by the Institute on December 19, 1988 and March 31, 1989. The Institute demonstrated in these comment letters that the proposed IP programs would result in the creation and operation by the Exchanges and the OCC of investment companies subject to, and not lawfully exempted from, the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1, *et seq.* (1981 & Supp. 1989).

At an open Commission meeting held on March 14, 1989, the SEC orally approved the proposed rule changes (8c, 4h-5h) and, on April 11, 1989, issued the two written Orders under review. In these Orders, the SEC rejected the contention of the Commodity Futures Trading Commission ("CFTC"), the CME and the CBOT that the SEC lacked the authority and jurisdiction to approve the proposed rule changes because IPs are stock index futures contracts subject to the exclusive jurisdiction of the CFTC (11f-15f, 25f-36f). The SEC concluded instead that, given the economic realities and economic substance of the instruments, IP longs and IP shorts are "securities" within the meaning of the federal securities laws because they provide investors with "a present interest in the current value of a portfolio of stock" (2f).

Notwithstanding this recognition, however, and in the teeth of its own admissions that IP programs involve, in economic substance, the creation and operation of investment companies, the SEC declined to apply to the IP programs the comprehensive statutory framework Congress enacted in the Investment Company Act to protect investors in investment companies. Forsaking the very economic reality and economic substance it had announced as the touchstone of its analysis, the SEC stated that the Investment Company Act has no application because the IP programs supposedly involve no "issuer" within the meaning of the Act (36f).

### E. The Proceedings Below

Immediately following the Commission's open meeting, the CME and the CBOT sought judicial review of the SEC's actions in the United States Court of Appeals for the Seventh Circuit.<sup>11</sup> On May 12, 1989, the Institute sought review of the Exchange Order and the OCC Order in the United States Court of Appeals for the Third Circuit, *Investment Company Institute v. Securities & Exchange Comm'n*, No. 89-3315 (3d Cir. May 12, 1989), and thereafter moved to transfer its Petition to the Seventh Circuit pursuant to 28 U.S.C. § 2112(a) (Supp. 1989). On May 16, 1989, the Third Circuit granted the motion to transfer, *Investment Company Institute v. Securities & Exchange Comm'n*, No. 89-3315 (3d Cir. May 16, 1989) (order denying stay), and the Seventh Circuit consolidated the Institute's Petition, renumbered No. 89-2012, with the Petitions for Review previously filed by the CME and CBOT (3d).

On August 18, 1989, a panel of the Court of Appeals issued an opinion declaring the Exchange Order and the OCC Order to be contrary to law on the grounds that IPs are "contracts \* \* \* for future delivery" subject to the exclusive jurisdiction of the CFTC (9c-24c). In light of this holding, the panel opinion expressly found no need to and expressly did not reach the merits of the Institute's Petition for Review (25c). The Seventh Circuit entered a single judgment which granted the CME and CBOT Petitions for Review, thereby invalidating the SEC Orders, and which dismissed the Institute's Petition for Review as "moot" in light of the disposition of the CME and CBOT Petitions for Review (2b).

<sup>11</sup> Following the SEC's open meeting, the CME and CBOT filed a Petition for Review (No. 89-1538) of the SEC's oral ruling in the Seventh Circuit. Then, on April 12, 1989, the CME and CBOT filed a Petition for Review (No. 89-1763) of the Exchange Order in the Seventh Circuit, and on April 17, 1989, the CME and CBOT filed a Petition for Review (No. 89-1786) of the OCC Order in the same court. The Seventh Circuit subsequently ordered the consolidation of these three cases. In its decision on the merits, however, the Seventh Circuit dismissed the Petition for Review of the Commission's oral decision approving the proposed rule changes for want of a "reviewable order" (1b, 8c).



### REASONS FOR GRANTING THE WRIT

In this Court, as in the Court of Appeals, the Institute takes no position with respect to whether the IP programs approved by the SEC Orders constitute "contracts \* \* \* for future delivery" within the meaning of the Commodity Exchange Act subject to the exclusive jurisdiction of the CFTC, as determined by the Court of Appeals, or constitute "securities" within the meaning of the federal securities laws subject to the jurisdiction of the SEC, as determined by the Commission. Rather, the Institute's position here, as in the Court of Appeals, is that if IPs are not "futures" but are "securities," then IP programs also involve the creation and operation of "investment companies" subject to the requirements of the Investment Company Act of 1940. Because the SEC refused to apply the protections of the Investment Company Act to investors in the IP programs at issue, the Institute submits that the SEC Orders are contrary to law and must be set aside.

As noted above, the Seventh Circuit below did not consider the applicability of the Investment Company Act to the IP programs, but dismissed the Institute's Petition for Review as moot in light of its conclusion that IPs are futures subject to the exclusive jurisdiction of the CFTC. The purpose of the instant petition is to ensure that, in the event this holding of the Seventh Circuit is reviewed and reversed, the Institute's timely and proper Petition for Review and the application of the Investment Company Act to the IP programs are considered and decided on the merits.

The Institute respectfully submits that, in the event this Court were to grant the petitions for Writs of Certiorari filed on behalf of the Exchanges and the OCC, there are two equally appropriate ways to proceed with respect to the instant petition. One course would be to hold the petition in abeyance pending review of the Seventh Circuit's holding that IPs are futures subject to the exclusive jurisdiction of the CFTC. Then, if the Court were to reverse the Seventh Circuit and affirm the SEC Orders to the extent they conclude

that IPs are securities, the Court could, and should, grant the instant petition, vacate the judgment of mootness in No. 89-2012 below and remand to the Seventh Circuit with instructions to consider the Investment Company Act issues raised by the Institute's Petition for Review.

The other equally appropriate course would be to grant the petition immediately and to consider the applicability of the Investment Company Act along with the issues presented by the Exchanges and the OCC. Although the Institute recognizes that this Court ordinarily does not consider in the first instance issues that were presented to, but that were not ruled upon by, a Court of Appeals, the Institute submits that there are substantial and compelling reasons for doing so in the context of this case.

*First.* This case presents fundamental questions of national importance. These issues relate not only to the allocation of regulatory jurisdiction over IPs and similar products between the CFTC and the SEC, but also to the existence and scope of the SEC's power effectively to repeal, through administrative fiat, the comprehensive statutory scheme Congress enacted in the Investment Company Act for the protection of investors in investment companies. These issues are of enormous practical and economic significance. While the Orders under review approve IP programs offered by three of the nation's major stock exchanges, it is likely that all the nation's other stock exchanges will follow suit and that similar IP programs will be offered to millions of investors throughout the country in the event the Orders are reviewed and upheld by this Court.

*Second.* The basic and fundamental questions posed under the Investment Company Act are fully developed on the record before this Court. All the relevant facts concerning the structure and operation of the IP programs were explored and compiled during the administrative proceedings conducted by the SEC. The Institute submitted two extensive comment letters to the Commission during those proceedings

demonstrating the applicability of the Investment Company Act to the IP programs (11f nn.30, 31) and the Commission considered and addressed the application of the Investment Company Act in the Orders under review (36f-37f). The parties also fully briefed and argued the Investment Company Act questions before the Court of Appeals. A remand thus is unnecessary to develop the factual record or to crystallize the issues before this Court.

*Third.* The issue of whether the Investment Company Act applies to the IP programs under review presents a pure question of law. It involves straightforward questions of statutory construction concerning which the agency that administers the statute has spoken and as to which this Court has the ultimate decision making authority. Because the question presented involves solely the "quintessential judicial function," *BATF v. FLRA*, 464 U.S. 89, 98 n.8 (1983), of determining what the Investment Company Act means, this Court's performance of that function, at the same time it resolves the pure questions of law raised by the Exchanges and the OCC, would serve the interests of judicial economy and would maximize efficient allocation of scarce judicial resources.

*Fourth.* The SEC Orders rest upon an interpretation of the Investment Company Act which contravenes longstanding judicial and administrative authority and which undermines the legislative purpose of the Investment Company Act. Although the SEC admitted that the IP programs involve, in economic substance, the creation and operation of investment companies, the Commission declared the Act inapplicable on the grounds that IP programs involve no "issuer" within the meaning of the Act. This conclusion was based in turn on the notion that no "fund" exists in the context of an IP program because the moneys contributed by IPs longs to the program

are not commingled in a single "completely segregated account" (37f).<sup>12</sup>

This wooden and stilted reading of the Act, however, simply cannot be squared with heretofore unbroken and dispositive precedent. Since at least as early as 1970, the Commission has repeatedly held that the Investment Company Act is not avoided by the simple expedient of holding investor monies in several separate, rather than one single, account.<sup>13</sup> Rather, where the separate accounts receive not

<sup>12</sup> Section 3(a) of the Investment Company Act, 15 U.S.C. § 80a-3(a) (1981), defines the term "investment company" to include any "issuer" that is "engaged primarily \* \* \* in the business of investing, reinvesting, or trading in securities." 15 U.S.C. § 80a-3(a) (1981). The Act also defines the term "issuer" to mean "every person who issues or proposes to issue any security," *id.* § 80a-2(a)(22) (1981), and "person" to include both "a natural person or a company." The Act further defines the term "company" to mean "a corporation, \* \* \* a trust, a fund, or any organized group of persons whether incorporated or not." *Id.* §§ 80a-2(a)(8), (28) (1981). As a result of the interplay of these provisions, any "fund" or "any organized group of persons" that is engaged primarily in the business of "investing, reinvesting or trading" in "securities" and that also issues "securities" is an "investment company."

<sup>13</sup> *Josephthal & Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,116, at 85,125 (Nov. 25, 1974). *See Securities & Exchange Comm'n v. First National City Bank*, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,592, at 98,707 (S.D.N.Y. Feb. 6, 1970); *Jacobs Persinger & Parker*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,053, at 80,296 (Feb. 4, 1971); *Finanswer America/Investments, Inc.*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,111, at 80,405 (Mar. 26, 1971); *Argus Securities Management Corp.*, SEC No-Action Letter (publicly available Jan. 8, 1972) [available on Lexis]; *Abraham & Co.*, SEC No-Action Letter (publicly available May 18, 1972) [available on Lexis]; *O'Brien Sherwood Associates, Inc.*, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,339, at 83,019 (Apr. 2, 1973); *Benchmark Securities, Inc.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,424, at 86,117 (Jan. 9, 1976); *Scudder, Stevens & Clark*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77, 641, at 78,932 (July 20, 1983); *AMA Advisors, Inc.*, SEC No-Action Letter (publicly available May 18, 1987) [available on Lexis]; *Scudder Fund Management Service*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,846, at 78,284 (Aug. 17, 1988). *See also Individualized Investment Management Services*, Investment Company Act Release No. 11,391, 21 SEC Docket 183 (Oct. 10, 1980).



individualized but identical investment services, the Commission has uniformly treated the formally separate accounts as the single fund that, in economic substance, they obviously are.<sup>14</sup>

The Commission's prior, but now apparently abandoned, precedent is fully consistent with, and indeed mandated by, the language of the Investment Company Act and judicial decisions demanding a "functional" reading of the Investment Company Act's terms. The Act provides that "the national public interest and the interest of investors are adversely affected" when investment companies operate outside the requirements of the Act, 15 U.S.C. § 80a-1(b) (1981), and embodies Congress' express directive that "the provisions of [the Act] shall be interpreted" to "mitigate and, so far as is feasible, to eliminate" this condition. *Id.* As a result, this Court has made clear that the protections of the Act are of "particular relevance to situations where the investor is committing his funds to the hands of others on an equity basis, with the view that the funds will be invested in securities and his fortunes will depend on the success of the investment." *Securities & Exchange Comm'n v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 79 (1959) (Brennan, J., concurring). "Congress intentionally drafted the statutory definitions in general terms in order to control such situations *regardless of the legal form or structure of the investment enterprise.*"<sup>15</sup> The

<sup>14</sup> It is undisputed that the accounts here involved receive no individualized investment service. The monies paid for a long IP are not used to invest in any particular or identifiable short IP. Indeed, the OCC does nothing but randomly and temporarily bring together outstanding long positions with outstanding short positions at each critical point in the operation of the IP programs: when the money contributed by IP longs is used to invest in IP shorts; when dividend equivalents are paid to IP longs (9g), and when longs seek to redeem their IPs at the cash-out times permitted by the Exchanges (5f-6f).

<sup>15</sup> *Prudential Insurance Co. v. Securities & Exchange Comm'n*, 326 F.2d 383, 386 (3d Cir.) ("*Prudential*") (emphasis supplied), cert. denied, 377 U.S. 953 (1964). See also *Reves v. Ernst & Young*, No. 88-1480, slip op. at 4 (U.S. Feb. 21, 1990); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 848 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967);

foregoing precedent — not even mentioned, much less distinguished, in the Orders under review — plainly controls the outcome of this case.

But, even assuming *arguendo* that the absence of a single "completely segregated account" means the lack of an "issuer" under the "fund" prong of the statutory definition of the term "issuer," an "issuer" nonetheless exists by virtue of the "organized group of persons" prong of the statutory definition of the term "issuer." Through the continual process of selling long IPs to investors, the Exchanges and the OCC are forming an "organized group of persons" consisting of the holders of long IPs. That these holders of long IPs were not organized before the Exchanges and the OCC embarked upon their IP programs does not alter this conclusion. *In the Matter of the Prudential Insurance Company*, Investment Company Act Release No. 3620 [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,891, at 81,283, 81,290 (Jan. 22, 1963). Indeed, as the Commission previously has held, to argue otherwise "is to argue that a group is not a group [merely] because it was some other person who brought it together." *Id.*<sup>16</sup>

*Securities & Exchange Comm'n v. W. J. Howey Co.*, 328 U.S. 293, 298 (1946).

<sup>16</sup> The SEC has recognized in numerous other cases as well that individuals may constitute an "organized group of persons" that forms an "issuer" and thus an "investment company" despite their lack of self-organization. For example, the SEC has held that individual brokers who purchase participations in commercial notes constitute an "investment company" under the "organized group of persons" theory. *National Association of Securities Dealers, Inc.*, SEC No-Action Letter (publicly available Feb. 23, 1975) [available on Lexis]. And, the SEC has held that individual participants who hold participations in certificates of deposit constitute an "investment company" for this same reason. *Lawyers Financial Corporation*, SEC No-Action Letter (publicly available May 25, 1975) [available on Lexis]. By deviating from this precedent in the context of individuals who hold "participations" in stock index investments, the Orders simply ignore the "fundamental intent and philosophy" of the Act to provide "protections to investors" in investment companies and indulge in the sort of "rigid" analysis that Congress, and heretofore the Commission, expressly have condemned. *In the Matter of The Prudential Insurance*



This functional interpretation of the Act again has been blessed by the courts. In *Prudential*, for example, the Third Circuit specifically rejected the argument apparently advanced in this case by the Commission that the term "organized group of persons" refers to only "legal" or "recognizable business entities." See *Prudential*, 326 F.2d at 387. Rather, based upon its review of the Act's legislative history, the Court determined that a "group of individual investors \* \* \* not a legal entity but rather constitut[ing] in essence a combination of distinct individual interests" was among the types of investment companies Congress intended the Act to govern. *Id.* at 387 (quoting H.R. Doc. No. 707, 75th Cong., 3d Sess. 24 (1939)).

The legislative purpose of the Investment Company Act confirms that the IP programs involve the creation and operation of investment companies. The Act represents Congress' considered legislative judgment that "the national public interest and the interests of investors are adversely affected" when investment companies operate outside the requirements of the Act. 15 U.S.C. § 80a-1(b) (1981). Specifically, Congress determined that it violates fundamental federal policy when investors purchase, pay for, sell or surrender investment company securities "without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management," *id.* § 80a-1(b)(1) (1981); when investment company operations "are not subjected to adequate independent scrutiny," *id.* § 80a-1(b)(5) (1981); and when investment companies change "the character of their business" without "the consent of their security holders," *id.* § 80a-1(b)(6) (1981). In order to remedy these conditions, Congress set forth in the

*Company, Investment Company Act Release No. 3620 [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,891, at 81,287 (Jan. 22, 1963), aff'd sub nom. Prudential Insurance Company v. Securities & Exchange Comm'n, 326 F.2d 383 (3d Cir.) ("Prudential"), cert. denied, 377 U.S. 953 (1964); see also In the Matter of International Funeral Services, 46 S.E.C. 214, 218 n.18 (1976).*

Act an array of carefully crafted, specific statutory protections designed to protect investors in investment companies from these abuses. As demonstrated below, however, the IP programs either do not provide, or expressly contravene, the safeguards Congress enacted for the protection of investors and the "national public interest."

— Congress mandated that management investment companies operate under the oversight of an *independent* Board of Directors elected by the company's investors and duty-bound to monitor the investment company's operations. 15 U.S.C. §§ 80a-10(a) (1981); 80a-16(a) (1981). In the context of the IP programs, however, no such independent "watchdog" committee exists to protect investors or to oversee the actions of the OCC and the Exchanges in the management of their IP programs.

— Congress mandated that an investment adviser to an investment company must be registered under and comply with the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 - 80b-21 (1981 & Supp. 1989). The adviser is not only subject to the investment company's code of ethics, *see id.* § 80a-17(j) (1981); 17 C.F.R. § 270.17j-1 (1989), to the antifraud provisions of the Advisers Act, *see* 15 U.S.C. § 80b-6, (Supp. 1989) and to the special disclosure requirements of the Advisers Act, *see* 17 C.F.R. § 275.206(4)-4 (1989), but also may be terminated by the Board of Directors or by a vote of a majority of the Investment Company's outstanding shares "at any time." 15 U.S.C. § 80a-15(a) (1981). Here, neither the OCC nor the Exchanges has registered under the Investment Advisers Act, and investors in the IP programs do not receive the benefits of these safeguards.

— Securities of open-end investment companies are, and must be, freely redeemable on a daily basis. 15 U.S.C. § 80a-22(e) (Supp. 1989); *see* SEC Rule 22c-1,

17 C.F.R. 270.22c-1 (1989). The Exchanges and the OCC, however, have severely and unlawfully limited the redemption right of IP holders.<sup>17</sup>

— The Investment Company Act provides that investors in investment companies may not have their shares redeemed involuntarily except in the most exceptional of circumstances. *See Investment Company Institute*, SEC No-Action Letter (publicly available May 1, 1975) [available on Lexis]. In the IP programs, however, investors are subject to the risk of routine involuntary redemption and liquidation (6f, 18g-19g).

— To protect investors against broker-dealer conflicts of interest and against precipitous price declines that could otherwise force the redemption of their shares, Section 11 of the Securities Exchange Act, 15 U.S.C. § 78k, and SEC Rule 11(d), 17 C.F.R. 240.11d1-2 (1989), forbids brokers to extend credit for the purchase of open-end investment company shares and substantially limits the ability of brokers to accept such shares as collateral in margin accounts. Yet, even though the same conflicts of interest, incentives and dangers are present in the context of the IP programs, brokers are permitted to sell IPs to investors on credit, and to accept IPs as collateral in margin accounts, without limitation (22f, 49f-50f).

— Section 8 of the Investment Company Act requires all investment companies to file with the Commission a registration statement containing such information "prescribe[d] as necessary or appropri-

<sup>17</sup> Holders in the CBOE program may redeem only semi-annually (4c-5c, 4f), while holders in the programs of the PHLX and the AMEX may redeem only quarterly (4c, 2f). And, although holders of IPs in the PHLX program may redeem at times other than the quarterly cash-out date, they may do so only on payment of a special fee (4c, 2f-3f). Even that redemption right is subject to alteration at any time pursuant to PHLX's management of that program (7g n.18).

ate in the public interest or for the protection of investors," including a precise statement of the company's investment objectives and policies. *See* 15 U.S.C. §§ 80a-8(a), (b) (1981). Investment companies also are required, pursuant to Item 2 of Form N-1A, to provide a shareholder transaction expense table and an annual fund operating expense table, both of which are designed to pull all the relevant fund expense information together in one place, in a uniform format, to allow prospective investors to compare the expenses applicable to investment companies. Moreover, investment companies are also required to provide to investors information related to their redemption policies and a wide range of other information. Investors in IPs, however, receive *none* of this disclosure. There is thus no meaningful way for an investor to evaluate the costs, risks and potential returns involved in the IP programs or to compare IP programs with each other or with investments in registered investment companies.<sup>18</sup>

<sup>18</sup> It is undisputed that, contrary to the requirements of the Investment Company Act, investors in the IP programs receive no disclosure concerning the identities or composition of the indexes upon which the IPs are traded; the conditions under which the composition of the indexes can be changed; whether the indexes can be deemed representative of a claimed market or sector; the diversification and concentration of the indexes; and whether and the manner in which the components of the indexes are "weighted." In fact, as to index composition, the Exchanges reserve the right to alter that composition at will (6f-8f), and the OCC disclaims all responsibility for the consequences of any such adjustment. Moreover, investors in the IP programs receive no disclosure of the fees and expenses, such as sales commissions or redemption charges, investors will incur in buying and redeeming IPs. Investors also receive no specific financial information concerning the soundness of the OCC clearing members or brokers involved in the IP programs, even though an investor's receipt of the value of his investment upon redemption depends upon the performance of these intermediaries. *See supra* notes 8, 9 at pp. 8, 9.



## CONCLUSION

For the reasons set forth above, in the event the Court grants the Petitions for Writs of Certiorari filed on behalf of the Exchanges and the OCC, the instant Conditional Petition for a Writ of Certiorari also should be granted.

Respectfully submitted,

/s/ HARVEY L. PITT

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Dated: March 22, 1990

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APPENDIX A

IN THE  
UNITED STATES COURT OF APPEALS  
FOR THE SEVENTH CIRCUIT

Nos. 89-1538, 89-1763, 89-1786, and 89-2012

CHICAGO MERCANTILE EXCHANGE, BOARD OF  
TRADE OF THE CITY OF CHICAGO, and  
INVESTMENT COMPANY INSTITUTE,

*Petitioners,*

v.

SECURITIES AND EXCHANGE COMMISSION,

*Respondent,*

and

PHILADELPHIA STOCK EXCHANGE, INC.,  
OPTIONS CLEARING CORPORATION,  
AMERICAN STOCK EXCHANGE, INC., and  
CHICAGO BOARD OPTIONS EXCHANGE, INC.,

*Intervening Respondents.*

On Petitions for Rehearing and  
Suggestions of Rehearing En Banc

Decided October 23, 1989

Before BAUER, *Chief Judge*, EASTERBROOK, *Circuit Judge*, and FAIRCHILD, *Senior Circuit Judge*.



PER CURIAM. The petition for rehearing filed by the Securities and Exchange Commission relies on a portion of 7 U.S.C. §2 added by the Accord legislation of 1982. This language provides:

[E]xcept as hereinabove provided, nothing contained in this section shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission . . . or (ii) restrict the Securities and Exchange Commission . . . from carrying out [its] duties and responsibilities in accordance with such laws.

As the Commission observes, our opinion did not discuss this part of the statute. We had not overlooked this text but rather had concluded that it afforded the SEC no comfort.

Although the Commission's jurisdiction continues "except as hereinabove provided", what is "provided" immediately above in §2 is that "the [CFTC] shall have exclusive jurisdiction . . . with respect to . . . transactions involving contracts of sale of a contract for future delivery, traded or executed on a contract market . . . or any other board of trade, exchange, or market". If IPs are futures contracts, then the CFTC has exclusive jurisdiction, the "except" clause applies, and the remainder of the language on which the SEC now relies has no force. It reminds us that the CFTC does not have powers Congress did not confer—that §2 carries no implicit preemptive force—but it does not help answer the question whether a given instrument is a futures contract.

The SEC's remaining arguments in support of rehearing flow from the proposition that IPs are equivalent to securities portfolios from the perspectives of the longs. Our opinion conceded as much, while observing that IPs just as surely look like futures contracts from the perspective of the shorts. Neither of these is the "privileged" perspective, and it is inappropriate to emphasize one over the other in order to direct jurisdiction to one agency rather than the other. This

duality is one of the principal ingredients in our conclusion that IPs are both securities and futures contracts. IPs are investment vehicles as longs see things; yet IPs are not capital-raising vehicles, given the nature of the shorts' commitments. Congress might think it wise to relax the exclusivity clause that lies at the heart of this dispute; so long as that clause remains, however, jurisdictional clashes of the sort represented here are inevitable, and the need to draw a line does not suggest that the first agency to assert jurisdiction ought to be the winner.

The Philadelphia Stock Exchange takes issue with note 3 of our opinion, which said that "none of the parties to the case suggests that the Philadelphia's product should be treated differently" because of its daily cash-out-at-a penalty feature. Our observation may be misleading. Page 12 of the Philadelphia's reply brief states:

[I]t is important to note that [our IP] has a daily, not quarterly, cash-out provision. Therefore, assuming *arguendo* as true the CME's and CBT's notion that a quarterly cash-out carries with it an element of futurity, a daily cash-out cannot be equated with a futures contract's quarterly expiration. Even in a stock transaction, the settlement period for delivery of the stock is 5 days. A daily cash-out, which is a feature unique to [our IP], eliminates any element of futurity.

This statement, in passing in a reply brief, does not come to grips with the fact that the Philadelphia's daily cash-out feature carries a penalty; 100% cash-out may be achieved only by waiting for the quarterly date. Deferred settlement of an ordinary stock trade occurs at a price fixed on the date of the trade; IPs are valued as of a future date. No party argued that daily cash out *at a penalty* eliminates all elements of futurity from the IP. We did not consider, and we do not decide the appropriate classification of, an IP with a daily cash-out feature at no penalty.

None of the other arguments in the petitions for rehearing requires further comment. The petitions are denied. A judge in active service called for a vote on the suggestions of rehearing en banc, which failed to attain a majority. Judges Cudahy and Ripple voted to rehear the case en banc. Judge Flaum took no part in the consideration or decision of this case.

A true Copy:

Teste:

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*Clerk of the United States  
Court of Appeals for the  
Seventh Circuit*

## APPENDIX B

### UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT CHICAGO, ILLINOIS 60604

August 18, 1989

Before

Hon. WILLIAM J. BAUER, Chief Judge  
Hon. FRANK H. EASTERBROOK, Circuit Judge  
Hon. THOMAS E. FAIRCHILD, Senior Circuit Judge

CHICAGO MERCANTILE EXCHANGE,  
BOARD OF TRADE OF THE CITY OF  
CHICAGO, and

INVESTMENT COMPANY INSTITUTE,  
Petitioners,

Nos. 89-1538, 89-1763,  
89-1786, 89-2012

vs.

SECURITIES AND EXCHANGE  
COMMISSION,  
Respondent,

and

PHILADELPHIA STOCK EXCHANGE, INC.,  
OPTIONS CLEARING CORPORATION,  
AMERICAN STOCK EXCHANGE, INC.,  
and CHICAGO BOARD OPTIONS  
EXCHANGE, INC.,  
Intervening Respondents.

Petitions for  
Review of  
Orders of the  
Securities and  
Exchange  
Commission.

These causes came before the Court for decision on the record from the Securities and Exchange Commission.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the petition for review in No. 89-1538 is DISMISSED for want of jurisdiction. On petitions Nos. 89-1763 and 89-1786, the SEC's orders approving the

applications of the stock exchanges and the OCC are SET ASIDE. Petition for review in No. 89-2012 is DISMISSED as moot in light of the decision in Nos. 89-1763 and 89-1786, in accordance with the opinion of this Court filed this date. Respondents recover costs in No. 89-1538. Petitioners recover costs in Nos. 89-1763 and 89-1786. No costs awarded in No. 89-2012.

## APPENDIX C

### IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Nos. 89-1538, 89-1763, 89-1786, and 89-2012

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CHICAGO MERCANTILE EXCHANGE, BOARD OF TRADE  
OF THE CITY OF CHICAGO,  
AND INVESTMENT COMPANY INSTITUTE,

*Petitioners,*

v.

SECURITIES AND EXCHANGE COMMISSION,

*Respondent,*

and

PHILADELPHIA STOCK EXCHANGE, INC.,  
OPTIONS CLEARING CORPORATION,  
AMERICAN STOCK EXCHANGE, INC., AND  
CHICAGO BOARD OPTIONS EXCHANGE, INC.,

*Intervening Respondents.*

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Petitions for Review of Orders of the Securities  
and Exchange Commission.

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Argued June 9, 1989—Decided August 18, 1989

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Before BAUER, *Chief Judge*, EASTERBROOK, *Circuit Judge*, and FAIRCHILD, *Senior Circuit Judge*.

EASTERBROOK, *Circuit Judge*. The Commodity Futures Trading Commission has authority to regulate trading of fu-



tures contracts (including futures on securities) and options on futures contracts. The Securities and Exchange Commission has authority to regulate trading of securities and options on securities. If an instrument is both a security and a futures contract, the CFTC is the sole regulator because "the Commission shall have exclusive jurisdiction with respect to . . . transactions involving . . . contracts of sale (and options on such contracts) for future delivery of a group or index of securities (or any interest therein or based upon the value thereof)", 7 U.S.C. §2a(ii). See also 7 U.S.C. §2 ("the Commission shall have exclusive jurisdiction, except to the extent otherwise provided in section 2a of this title"); *Chicago Board of Trade v. SEC*, 677 F.2d 1137 (7th Cir.), vacated as moot, 459 U.S. 1026 (1982) (*GNMA Options*). If, however, the instrument is both a futures contract and an option on a security, then the SEC is the sole regulator because "the [CFTC] shall have no jurisdiction to designate a board of trade as a contract market for any transaction whereby any party to such transaction acquires any put, call, or other option on one or more securities . . . including any group or index of such securities, or any interest therein or based on the value thereof." 7 U.S.C. §2a(i).

The CFTC regulates futures and options on futures; the SEC regulates securities and options on securities; jurisdiction never overlaps. Problem: The statute does not define either "contracts . . . for future delivery" or "option"—although it says that "future delivery" . . . shall not include any sale of any cash commodity for deferred shipment or delivery". See Lester G. Telser, *Futures and Actual Markets: How They Are Related*, 59 J. Business S5 (1986). Each of these terms has a paradigm, but newfangled instruments may have aspects of each of the prototypes. Our case is about such an instrument, the index participation (IP). We must decide whether tetrahedrons belong in square or round holes.

## I

Index participations are contracts of indefinite duration based on the value of a basket (index) of securities. The seller of an IP (called the "short" because the writer need not own the securities) promises to pay the buyer the value of the index as measured on a "cash-out day". Any index, such as the Standard & Poor's 500, can be used. The buyer pays for the IP in cash on the date of sale and may borrow part of the price (use margin) on the same terms the Federal Reserve sets for stock—currently 60%. The exchange designates a conversion ratio between the index and the IP, so that (say) each IP unit entitles the holder on cash-out day to the value of the index times 100. Until cash-out the IP may trade on the exchange just like any other instrument. At the end of each quarter the short must pay the buyer (the "long") a sum approximating the value of dividends the stocks in the index have paid during the quarter. From the perspective of the long, then, an IP has properties similar to those of a closed-end mutual fund holding a value-weighted portfolio of the securities in the index: the IPs last indefinitely, pay dividends, and may be traded freely; on cash-out day the IP briefly becomes open-end, and the investor can withdraw cash without making a trade in the market.

Things differ from the short's perspective. Unlike the proprietor of a mutual fund, the short need not own the securities in the index; it will own them (equivalently, a long futures contract based on the same index) only to reduce risk. The short receives the long's cash but must post margin equal to 150% of the value of the IP, similar to the margin required for a short sale of stock. The short sees the IP as a speculative or hedging instrument scarcely distinguishable from a futures contract that terminates on the cash-out day, plus an option held by the long to roll over the contract to the next cash-out date. Cash-out days for an IP generally are the third Friday of March, June, September, and December, the expiration dates of the principal stock-index futures contracts, making the link even more apparent.

Longs and shorts do not deal directly with each other. After the parties agree on the price, the Options Clearing Corporation (OCC) issues the IP to the long, receiving the cash; at the same time the OCC pays the short and "acquires" the short's obligation to pay at cash-out time. OCC guarantees the short's obligations to the long, to secure which it holds the short's 150% margin. As the quarter progresses the short must pony up cash to cover dividend-equivalent obligations. When a long exercises the cash-out privilege, the OCC chooses a short at random to make the payment. Any link between the original buyer and seller of an IP thus does not extend beyond the formation of the instrument; after that instant, each person's rights and obligations run to the OCC exclusively. This arrangement also permits either party to close its position by making an offsetting transaction. If the seller of an IP buys an identical contract in the market, the OCC cancels the two on its books.

The Philadelphia Stock Exchange asked the SEC in February 1988 for permission to trade IPs. The American Stock Exchange and the Chicago Board Options Exchange later filed proposals of their own. Each exchange's IP differs slightly from the others. Philadelphia's IP, called a "Cash Index Participation", allows the long to exercise the cash-out privilege on any business day, at a discount of 0.5% from the value of the index. (The long may cash out on a quarterly date without penalty.) The AMEX's IP, called the "Equity Index Participation", permits the long to cash out quarterly for money or shares of stock in a ratio matching the index. Holders of 500 or more EIP trading units based on the S&P 500 index (each the equivalent of 100 multiples of that index) may exercise the right to receive securities, and they must pay a "delivery charge" to be established by the AMEX. Writers of EIPs may volunteer to deliver stock; if not enough do, a "physical delivery facilitator" at the AMEX will buy stock in the market, using money provided by the shorts whose positions have been liquidated. The CBOE's product, the "Value of Index Participation", has a semi-annual rather

than quarterly cash-out date. CBOE's wrinkle is that the short as well as the long may cash out, by tendering the value of the index on the cash-out date. If shorts seeking to close their positions exceed the number of longs who want cash, the OCC will choose additional long positions at random to pay off.

The three stock exchanges and the OCC asked the SEC to allow them to trade these varieties of IP. Each contended that the SEC has exclusive jurisdiction because IPs are securities and not futures contracts. The AMEX added that in its view an IP is an option on securities, activating the savings clause of §2a(i). The Chicago Board of Trade and the Chicago Mercantile Exchange, supported by the CFTC, asked the SEC to deny the requests. Each futures market, and the CFTC, argued that IPs are futures and not securities, so that the CFTC's jurisdiction is exclusive under 7 U.S.C. §§ 2 and 2a(ii). Complicating the picture, the Investment Company Institute argued that if IPs are securities and not futures, the OCC is an "investment company", offering a product combining features of closed-end and open-end mutual funds, and must register under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64.

On April 11, 1989, the SEC granted the exchanges' requests. Release No. 34-26709, 54 Fed. Reg. 15280 (1989). At the same time, its Division of Market Regulation, acting with delegated authority, allowed the OCC to change its rules so that it could issue, settle, and clear IPs. Release No. 34-26713, 54 Fed. Reg. 15575 (1989). The SEC concluded that IPs are "stock" within the meaning of §3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. §78c(a)(10). IPs are negotiable, pay dividends, may appreciate in value, and may be hypothecated; the only attribute of stock missing from IPs is voting rights, which the SEC thought unimportant. 54 Fed. Reg. at 15285-86. If not stock, the SEC concluded, IPs are "certificates of interest or participation in" stock, another of the instruments defined as "securities" in §3(a)(10). See



54 Fed. Reg. at 15286.<sup>1</sup> Next the SEC found that IPs are not "futures", *id.* at 15286-89, because they lack two features the SEC thought essential: "futurity" and "bilateral obligation". "Futurity" means that value is set in the future, while as the SEC observed the buyer of an IP pays a price fixed at the time of sale; "bilateral obligation" means that the contract is executory on both sides until expiration or settlement, while the long on an IP performs at the time of purchase, leaving only the short with executory obligations. The SEC went on to say, *id.* at 15289-90, that the OCC need not register under the Investment Company Act because there is no "issuer" within the meaning of §3(a)(1) of that statute, 15 U.S.C. §80-3(a)(1). Concluding that IPs may serve as substitutes for "program trading", provide "an additional layer of liquidity to the market", and afford "an alternative vehicle for retail customers to invest in 'the market'", 54 Fed. Reg. at 15290, the SEC allowed the exchanges to proceed with their plans. We denied the futures markets' request for a stay but accelerated the hearing of the case on the merits. IPs have been trading on the three exchanges since May.

## II

### Three preliminary matters.

First, the futures markets are not plagued by regulation of their own activities. They complain, instead, that the SEC has passed up an opportunity to throttle three competitors. The futures markets may obtain relief only if there is a case or controversy within the meaning of Article III, and then only if they fall within the zone of interests protected by the Securities Exchange Act and the exclusivity clauses of the Commodity Exchange Act. The last time a dispute of this character was before us, we held that the futures markets

<sup>1</sup> Commissioner Cox, while otherwise joining the SEC's opinion, disavowed reliance on the contention that IPs are "stock" but agreed with his colleagues that they are "certificates of interest or participation". 54 Fed. Reg. at 15293.

have standing, *GNMA Options*, 677 F.2d at 1140-41 n.4, but did not mention the "zone" question. Our opinion in *Chicago Board of Trade v. SEC*, No. 89-1084 (7th Cir. Aug. 17, 1989) (*Delta Options*), requires decision in the futures markets' favor. *Delta Options* concludes that the futures markets may challenge the registration of a clearing agency that facilitates transactions for their competitors, even though the futures markets' interests may be adverse to those of investors. Today's case is easier, because the exclusivity clauses of the Commodity Exchange Act are at least arguably there for the benefit of the futures markets. Too, if the SEC is right that IPs are not futures, then the futures markets not only must suffer competition with their existing contracts but also would be forbidden to trade IPs themselves. The CME and the CBOT consequently are proper parties to invoke judicial review.

Second, the futures markets lodged with the court a lengthy report the CFTC submitted to the Senate committee on Agriculture, Nutrition and Forestry explaining its position that it (and not the SEC) has jurisdiction of IPs. The stock exchanges ask us to strike this report because it is not part of the SEC's administrative record. They also want us to strike from the appendix affidavits of Todd E. Petzel that were prepared after the SEC's decision. We deny these motions. The CFTC's report to the Senate is a public document, which the court would be free to consult whether or not anyone had supplied it; lodging simply reduces the workload of the court's librarian. The Petzel affidavits, by contrast, are case-specific documents that may be presented only if part of the administrative record. *Wisconsin Electric Power Co. v. Costle*, 715 F.2d 323, 326-27 (7th Cir. 1983); cf. *Edison Electric Institute v. OSHA*, 849 F.2d 611, 623 n.16 (D.C. Cir. 1988). They are. Although prepared after the SEC's decision, they were submitted to that agency in support of the futures markets' request for a stay. The stock exchanges asked the SEC to strike them; it took no action on that request. So the affidavits entered the administrative record and may be included in the record here, for what they are worth. *Edison*

*Electric*; see also *Association of Pacific Fisheries v. EPA*, 615 F.2d 794, 811-12 (9th Cir. 1980) (Kennedy, J.).

Third, the SEC asks us to dismiss one of the petitions for review, No. 89-1538. The futures markets filed a petition the instant the SEC voted at a public meeting on March 14 to approve the trading of IPs. They filed additional petitions after the SEC issued its orders on April 11. Section 25(a)(1) of the '34 Act, 15 U.S.C. §78y(a)(1), which supplies this court's jurisdiction, authorizes review of "a final order of the Commission entered pursuant to this chapter". The petition shall be filed "within sixty days after the entry of the order". The Commission's Rules of Practice define "entry" as the date the order is adopted, reflected by its caption. Rule of Practice 22(k), 17 C.F.R. §201.22(k). Until the Commission has "entered" an "order", there is nothing to review. There is a big difference between a vote and an order. Only the order gives legal effect to the SEC's vote.

The futures markets contend that the vote is reviewable because the stock exchanges could have started to trade IPs immediately thereafter, and they refer to *ITT World Communications, Inc. v. FCC*, 621 F.2d 1201 (2d Cir. 1980), which accepted jurisdiction of a petition filed prior to the written order. The FCC's decision in *ITT* went into force before entry of a written document; bound by the decision, ITT, as the party being regulated, needed to file a petition to obtain a stay. The SEC's vote did not produce an immediately effective order. It did not require the futures markets to take any action. The vote (without the order) had no effect on the futures markets different in kind from a refusal (for the time being) to take action against their competitors. To see this, suppose that the stock exchanges had started trading IPs forthwith, and the SEC had done nothing. Inaction would be neither final nor reviewable, for the reasons given in *Delta Options*. The vote of March 14 was at most a clue that if the stock exchanges were to move aggressively, the SEC would not act. Petition No. 89-1538 is dismissed for want of a reviewable order.

### III

#### A

A futures contract, roughly speaking, is a fungible promise to buy or sell a particular commodity at a fixed date in the future. Futures contracts are fungible because they have standard terms and each side's obligations are guaranteed by a clearing house. Contracts are entered into without prepayment, although the markets and clearing house will set margin to protect their own interests. Trading occurs in "the contract", not in the commodity. Most futures contracts may be performed by delivery of the commodity (wheat, silver, oil, etc.). Some (those based on financial instruments such as T-bills or on the value of an index of stocks) do not allow delivery. Unless the parties cancel their obligations by buying or selling offsetting positions, the long must pay the price stated in the contract (e.g., \$1.00 per gallon for 1,000 gallons of orange juice) and the short must deliver; usually, however, they settle in cash, with the payment based on changes in the market. If the market price, say, rose to \$1.50 per gallon, the short would pay \$500 (50¢ per gallon); if the price fell, the long would pay. The extent to which the settlement price of a commodity futures contract tracks changes in the price of the cash commodity depends on the size and balance of the open positions in "the contract" near the settlement date. When the contract involves financial instruments, though, the price is fixed by mechanical computation from the instruments on which the contracts are based. See *Leist v. Simplot*, 638 F.2d 282, 286-87 (2d Cir. 1980) (Friendly, J.), affirmed on other grounds under the name *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982); Philip McBride Johnson & Thomas Lee Hazen, 1 *Commodities Regulation* §§ 1.03-.04, 1.10 (2d ed. 1989); Bryan Byrne, Jr., *The Stock Index Futures Market* (1987).

A security, roughly speaking, is an undivided interest in a common venture the value of which is subject to uncertainty. Usually this means a claim to the assets and profits of



an "issuer". Shares of stock entitle their holders to receive dividends and payments on liquidation (or a change in corporate form), see *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985); bonds and other debt instruments promise interest plus a balloon payment of principal at the end. Unusual interests such as rights in orange groves still may be "securities" if they represent a pro rata share of a variable pool of earnings. *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). See generally Louis Loss & Joel Seligman, 2 *Securities Regulation* 926-89 (3d ed. 1988).

Securities usually arise out of capital formation and aggregation (entrusting funds to an entrepreneur), while futures are means of hedging, speculation, and price revelation without transfer of capital. So one could think of the distinction between the jurisdiction of the SEC and that of the CFTC as the difference between regulating capital formation and regulating hedging. Congress conceived the role of the CFTC in that way when it created the agency in 1974 to assume functions that had been performed by the Department of Agriculture but which were no longer thought appropriate for that Department as futures markets expanded beyond commodities into financial instruments. See *GNMA Options* for a recap of the history. Unfortunately, the distinction between capital formation and hedging falls apart when it comes time to allocate the regulation of options.

A call option is a promise by the writer to deliver the underlying instrument at a price fixed in advance (the "strike price") if the option is exercised within a set time. The buyer pays a price (the "premium") in advance for the opportunity; the writer may or may not own the instrument he promises to deliver. Call options are written "out of the money"—that is, the exercise price exceeds the market price at the outset. The writer will make money if by the time the option expires the market price is less than the strike price plus the premium (plus the interest earned on the premium in the interim); the buyer of the option hopes that the market price will rise above the strike price by enough to cover the

premium, the time value of money, and the transactions costs of executing the option. Options play valuable roles in price-discovery, and they also allow the parties to adjust the net riskiness of their portfolios. Writers of call options reduce the risk they bear if the market falls while limiting gains if the market rises; buyers hope for large proportional gains if the market rises while accepting the likelihood that the options will turn out to be worthless. Options are side deals among investors, which do not augment an entrepreneur's coffers (except to the extent greater liquidity and opportunities to adjust risk increase social marginal propensity to invest). Dwight M. Jaffee, *The Impact of Financial Futures and Options on Capital Formation*, 4 J. Futures Market 417 (1984). Unlike financial and index futures, options call for delivery of the underlying instrument—be it a share of stock or a futures contract.

The SEC consistently has taken the position that options on securities should be regulated as securities. For some years the CFTC maintained that options on securities should be regulated as futures because options are extrinsic to capital formation and because it is almost always possible to devise an option with the same economic attributes as a futures contract (and the reverse). Matters came to a head in 1980, when both agencies asserted jurisdiction over options on securities based on pools of notes. The Government National Mortgage Association (GNMA) sold pass-through certificates representing proceeds of mortgage notes, and persons started writing options on them to allow hedging against movements in interest rates. The SEC observed that options written on securities are securities under §3(a)(10) of the '34 Act; indeed the SEC contended that because options are securities it should regulate all options. The CFTC countered that options on financial instruments are futures under §4c(b) of the CEA, 7 U.S.C. §6c(b), and added that because its jurisdiction is exclusive, it is the sole lawful regulator. When the SEC allowed stock exchanges to start trading GNMA options, the futures markets sought review in this court and the CFTC howled bloody murder.



While the case was pending, the agencies reached a pact, which the SEC calls the Shad-Johnson Agreement and the CFTC calls the Johnson-Shad Agreement. (John Shad was the SEC's Chairman at the time, and Phillip Johnson the CFTC's.) This Accord (as we shall call it to avoid offending either agency) provided that jurisdiction over options follows jurisdiction over the things on which the options are written. So the SEC received jurisdiction of options on securities, while the CFTC got jurisdiction of options of futures contracts. Things were not quite done, though, because we held in *GNMA Options* that the agencies could not alter their jurisdiction by mutual agreement. 677 F.2d at 1142 n.8. Starting from the proposition that options on GNMA's are both securities and futures, we held that the CFTC's jurisdiction is exclusive in light of 7 U.S.C. §§ 2 and 2a.

Congress then enacted the Accord almost verbatim, producing the explicit reference to options in §3(a)(10) of the '34 Act, the SEC savings clause in §2a(i) of the CEA, and a small change in 7 U.S.C. §6n to implement an understanding about pools. The legislature thought that this Accord would resolve things and restore a regime in which the SEC supervises capital formation and the CFTC hedging. See S. Rep. No. 97-384, 97th Cong., 2d Sess. 21-24 (1982); H.R. Rep. No. 97-565, 97th Cong., 2d Sess., Part I at 38-40 (1982); H.R. Rep. No. 97-626, 97th Cong., 2d Sess., Part II at 3 (1982); 128 Cong. Rec. 24910 (1982) (Rep. De La Garza); Loss & Seligman, 2 *Securities Regulation* at 1064-80; Jerry W. Markham & David J. Gilberg, *Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 Albany L. Rev. 741 (1983).

The legislation implementing the Accord left in place the premise on which *GNMA Options* was founded: if an instrument is both a security and a futures contract, then the CFTC's jurisdiction is exclusive. Section 2a(ii) has no other possible meaning. Like many an agreement resolving a spat, the Accord addressed a symptom rather than the problem. Options are only one among many instruments that can have

attributes of futures contracts as well as securities. Financial markets work best when they offer every possible combination of risk and return—a condition financial economists call “spanning”—so that investors can construct a portfolio to each need and taste. Exchanges and professional investors therefore continually devise financial products to fill unoccupied niches. See Dennis W. Carlton, *Futures Markets: Their Purpose, Their History, Their Growth, Their Successes and Failures*, 4 J. Futures Markets 237 (1984); William L. Silber, *Innovation, Competition and New Contract Design in Futures Markets*, 1 J. Futures Markets 123 (1981). These products are valuable to the extent that they do *not* match the attributes of instruments already available. New products, offering a new risk-return mixture, are designed to depart from today's models.

Which means that the dispute of 1980-82 about options will be played out—is being played out—about each new instrument. Today's case repeats the conflict. Other novel instruments are being handled by regulation. For example, on July 17, 1989, the CFTC adopted rules exempting from its regulation certain hybrid instruments combining equity or debt with payments based on the price of commodities. 17 C.F.R. Part 34, 54 Fed. Reg. 30684 (1989). Only merger of the agencies or functional separation in the statute can avoid continual conflict. Functional separation is hard to achieve (new instruments will appear at any border). The SEC favors merger; it has asked Congress repeatedly for jurisdiction over all products (including stock-index and financial futures) based on securities, which would relegate the CFTC to its original role as superintendent of commodities futures. The CFTC has so far defended its position, in part with the argument that multiple regulatory bodies allow greater competition and experimentation—a new product can reach market if either agency approves the variant within its domain. See Daniel R. Fischel, *Regulatory Conflict and Entry Regulation of New Futures Contracts*, 59 J. Business S85 (1986); Ronald W. Anderson, *The Regulation of Futures Contracts Innovations in the United States*, 4 J. Futures Markets 297 (1984).

Unless Congress changes the allocation of jurisdiction between the agencies, the question a court must resolve is the same as in *GNMA Options*: is the instrument a futures contract? If yes, then the CFTC's jurisdiction is exclusive, unless it is also an option on a security, in which case the SEC's jurisdiction is exclusive. So long as an instrument is a futures contract (and not an option), whether it is also a "security" is neither here nor there. Still, if IPs really are "stock" they almost certainly are not "futures contracts", so the inquiries aren't so distinct as the statutes imply.

## B

From the perspective of the long, IPs look like an interest in portfolio of stock. IPs last indefinitely (except for the chance that a long may be cashed out involuntarily on the CBOE), may be sold like stock or used to secure margin and other loans, change in value with the market, and pay dividends. IPs lack other common attributes of stock: they do not confer voting rights and are not "certificated"; owners of IPs receive dividend-equivalent payments quarterly, not when the firms pay dividends. We need not debate whether these differences come to anything, for they pale beside the larger difficulties in calling IPs "stock". The greatest is that IPs are not stock *in* anything. There isn't an issuer—which the SEC emphasized when concluding that the Investment Company Act is inapplicable, 54 Fed. Reg. at 15289-90. Stock is an equity interest in an issuer, the residual claim to the profits of a venture *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). *Landreth* rejected the "sale-of-business doctrine" because the owner of 100% of the equity interest in a firm still owns "stock".<sup>1</sup> Purchasers of IPs don't own eq-

<sup>1</sup> Attributes such as transferability, appreciation, and votes are useful to distinguish "real stock" from pieces of paper labeled "stock" that do not convey the ordinary interests of equity. *Landreth*, 471 U.S. at 686. Such documents had been issued in *Forman* as part of a residential co-op development. Transferability and the like are not talismans, however, but

uity, directly or indirectly; they don't have a claim to the proceeds and liquidating distribution of a business; there isn't an underlying pool of assets; there is only a "short" on the other side. The absence of an issuer—IPs don't carry votes because they don't have anything to do with equity—tells all. There is no common venture, not even the commonality represented by a mutual fund (which reinvests in real stock and creates the risk that the stakeholder will join Robert Vesco with the kitty).

IPs do not fit comfortably into any of the other pigeonholes of §3(a)(10). A "certificate of interest or participation in . . . any of the foregoing" securities is a security too, but IPs do not represent an "interest or participation" in the stocks in the index; they are based on the value of stock without creating a legal interest *in* stock. Perhaps the closest match is the language, part of the Accord in 1982, covering a "privilege on any security . . . or group or index of securities (including any interest therein or based on the value thereof)". Then there's the catch-all: "in general, any instrument commonly known as a 'security'". IPs convey privileges based on the value of an index, and what is "commonly known as a security" changes as new instruments come into use. So there is a basis for drawing IPs within §3(a)(10), even though they do not duplicate a recognized category. See also, e.g., *SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202 (1967).

Although the SEC found IPs to be securities by looking at the promises made *to* the longs, the CFTC found them to be futures by virtue of the promises made *by* the shorts, a perspective implied by the CEA's references to "contracts . . . for future delivery"—emphasizing the shorts' obligation. Shorts on IPs make the same pledge as shorts on

only ways to identify equity claims. Much real "stock" does not trade or appreciate in value, because it is covered by buy-sell agreements. (Closely held firms often provide that stock may be sold only to the firm, and then at a formula price.) It is nonetheless stock, as *Landreth* holds, because it is a real equity claim to a business.



stock-index futures contracts: to pay the value of an index on a prescribed day (the expiration date for the futures contract, the cash-out date for the IP). The short owes this obligation to the clearing house rather than to the long. IPs may be settled by buying or selling an offsetting obligation, after which the clearing house cancels the two on the books, just as with futures contracts. Shorts on IPs must put up more margin than shorts on futures contracts and must make dividend-equivalent payments, but the CFTC did not find these differences any more dispositive than the SEC found the IPs' lack of voting rights. Shorts also face an obligation of indefinite duration of the Philadelphia and AMEX IPs, but the CFTC and the futures markets treat this as no more than a prepaid rollover privilege.

Despite the congruence of futures and IPs on the short side, the SEC and the stock exchanges say that both "futures" and "bilateralism" are missing. According to the SEC, IPs lack "futures" because an IP is the "present obligation to pay current value." And IPs are not bilateral because the long performs in full by paying up front, although in a futures contract both sides must perform on settlement or expiration.

With respect to bilateralism, the SEC's point is inescapable. With respect to futures, the SEC is wrong. IPs are no more a "present obligation to pay current value" than are futures contracts. The holder of either an IP or a stock-index futures contract may go to market and trade it; the price necessarily tracks current value. Neither the long on an IP nor the long on a futures contract can compel the short to *pay* current value, however.<sup>3</sup> Both the futures contract and the IP are settled quarterly (the same dates for both kinds of instru-

<sup>3</sup> The daily cash-out-at-a-penalty feature of the Philadelphia's IP may oblige the short to pay "current" value less 0.5%, but none of the parties to the case suggests that the Philadelphia's product should be treated differently on this account. We therefore do not pursue it. Similarly, we bypass the delivery option in the AMEX IP and the short's opportunity to get out of the CBOE IP, both of which make IPs look more like futures.

ment, except for the CBOE's omission of two of the four dates). The short's obligation is to pay the value of the index *on that date*—which lies in the future to the same extent as the settlement date of any futures contract. Even from the long's point of view, IP and futures contract ultimately look the same. The long pays up front for the IP, but the long on a futures contract *promises* up front to make a defined payment on the settlement date; the difference in the timing of the payment does not affect the fact that valuation comes at the defined future date.

So the IP has futurity but not bilateralism. It looks like a futures contract to the short—except that it is of indefinite duration, carries a dividend-equivalent obligation, and requires higher margin. It looks like a mutual fund to the long—except that it has no voting rights, does not represent any interest in an underlying pool of stock, and may be settled by executing an offsetting transaction. Fact is, it is no less a future than it is a security, and no more. It just doesn't fit. Which is the whole point. It isn't supposed to be just like something else; the IP was designed as a novel instrument so that it could offer attributes previously missing in the market.

The only thing of which we are sure is that an IP is not an option on a security. The AMEX contends that it is a prepaid option, with a premium equal to the full value and an exercise price of zero. The SEC did not accept this contention, writing:

[W]hile IPs contain some characteristics of stock index options (e.g., the issuance and clearance and settlement features of IPs are analogous to those of stock index options), the Commission believes that IPs predominantly have the attributes of a portfolio of common stock.

54 Fed. Reg. at 15286 n.57. The only "characteristics of stock index options" that either the AMEX or the SEC identified are those introduced by the presence of a clearing house—characteristics that the IP shares with stock-index futures to the last detail. Unless we were to say that all futures are also



options (they aren't), these features do not make IPs options. The very features that the SEC emphasizes to show that IPs are securities—indefinite duration, payment up front in cash, dividend equivalency, and so on—show that IPs cannot be options. Options are written out of the money, limited in time, and establish a careful balance among premium, strike price, and duration; the writer retains dividends. IPs possess none of these distinguishing features. As the AMEX defines an "option", someone who buys an automobile for cash and drives it away really has obtained an option with a high premium, zero strike price, perpetual duration, and 100% probability of exercise. Words are useful only to the extent they distinguish some things from others; symbols that comprise everything mean nothing. IPs are not not options.

## C

Having concluded that neither the '34 Act nor the CEA addresses the status of IPs in a straightforward way, the logical thing to do is to defer to the agency's resolution of the problem. *Chevron U.S.A. Inc. v. Natural Resources Defense Counsel, Inc.*, 467 U.S. 837 (1984). But which agency? Each claims to be exercising its discretion; each claims entitlement to deference on a subject within its domain.

Although cases frequently say that courts should defer to the judgment of the responsible agency whenever the statute is ambiguous as applied to a subject, *e.g.*, *NLRB v. Hearst Publications, Inc.*, 322 U.S. 111 (1944), this is something of an oversimplification. Ambiguity does not necessarily dictate whether the court or the agency has the dispositive word. Many's the statute that drops a half-resolved dispute in the lap of the courts even though one or more agencies exercise jurisdiction. Think of the antitrust laws, which courts freely construe even though both the Antitrust Division of the Department of Justice and the Federal Trade Commission may lay claim to greater expertise. When a statute has gaps

and uncertainties—the status of all rules—the anterior question is: who is charged with filling the gaps? Often statutes delegate comprehensive powers to agencies, and the meaning of the law is that agencies shall solve novel problems as they arise. Solutions may involve complex and unanticipated adjustments. Courts can be more confident that power has been delegated than that any particular exercise is "right". Deference to the agency's conclusion follows naturally from such a determination, for what Congress wanted to obtain is the judgment of the agency—Congress delegates precisely because it cannot foresee and resolve all problems. See *Chevron*, 467 U.S. at 843-45; *Young v. Community Nutrition Institute*, 476 U.S. 974, 981-84 (1986); *Homemakers North Shore Inc. v. Bowen*, 832 F.2d 408, 411-12 (7th Cir. 1987); Henry P. Monaghan, *Marbury and the Administrative State*, 83 Colum. L. Rev. 1 (1983). When the agency is the addressee of the statutory command, it takes the leading part in giving structure to the statute; when the court is the addressee, it has the principal role.

When two agencies claim to be the addressees, though, this allocation breaks down. Perhaps a court could say that because the agencies disagree, neither is entitled to deference. Yet disagreement doesn't make the court the recipient of interpretive powers. One or the other agency is still in charge. Courts readily could accept both the SEC's application of the '34 Act to IPs and the CFTC's application of the CEA. Our difficulty is not any logical conundrum in deferring to both agencies when they disagree. It is instead that a dispute about the agencies' jurisdiction is a zero-sum game because of the exclusivity clauses in the CEA.

Any distinction between action under delegated powers and fixing the scope of delegation will break down at the edges, and some recent cases suggest that a court should not try to draw such a line in the first place—one of them concerning the scope of the CFTC's powers. *CFTC v. Schor*, 478 U.S. 833, 844-46 (1986); see also *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 108 S. Ct. 2428, 2444

(1988) (Scalia, J., concurring); *CSX Transportation v. United States*, 867 F.2d 1439, 1445 (D.C. Cir. 1989) (Edwards, J., dissenting) (suggesting that *Chevron* disallows inquiry into the extent of delegation, although that should be the right question). But even if unambiguous delegation is not a necessary condition of deference, it is an important ingredient in the formula, else it becomes impossible to distinguish statutes such as the Sherman Act from those such as the Clean Air Act, or to conceive where the boundary between court and commission falls. Delegation to agencies is not without its costs to the separation of powers; holding agencies within their delegated scope is an important task in maintaining constitutional structure.<sup>4</sup>

Difficulties in establishing the competence of the agencies and the judicial branch do not influence the outcome of this case, however. We may assume without deciding that even in this jurisdictional dispute, each agency is entitled to leeway in applying its own statute to IPs.

## D

If each agency's interpretation of its own statute is entitled to some deference, then the IP is both a security and a futures contract. It has some attributes of both, and all attributes of neither, as we have laid out in excessive detail. Neither characterization can be called wrong.

The only element of financial futures contracts that is missing is "bilateralism". Yet bilateralism is not essential to a futures contract. *CFTC v. Co Petro Marketing Group, Inc.*, 680 F.2d 573 (9th Cir. 1982), held that a contract that imposes

<sup>4</sup> See also Cynthia R. Farina, *Statutory Interpretation and the Balance of Power in the Administrative State*, 89 Colum. L. Rev. 452, 502-26 (1989); Richard J. Pierce, Jr., *Two Problems in Administrative Law*, 1988 Duke L.J. 300; Stephen Breyer, *Judicial Review of Questions of Law and Policy*, 38 Admin. L. Rev. 363 (1986); Clark Byse, *Judicial Review of Administrative Interpretation of Statutes*, 2 Admin. L.J. 255 (1988).

performance obligations only on the short may be a futures contract. Co Petro sold interests in gasoline that were designed to look like forward contracts, which under the CEA are not futures contracts. Buyers put down deposits to obtain Co Petro's promise to deliver gasoline on future dates. These contracts could not be traded on any market, but Co Petro promised to pay the investor in cash if the market price should rise (that is, the investor could sell the contract back to Co Petro). The investor risked no more than 95% of his deposit; if the price of gasoline fell, the investor's position would be closed. Thus buyers of Co Petro's contracts performed fully on the date they posted the deposit; thereafter only Co Petro had obligations. Despite that, and despite the fact that the contracts were illiquid, the court of appeals concluded that they were futures contracts because their value depended entirely on the price of the commodity at their expiration date, and they were not formed in contemplation of physical delivery.

The SEC brushes off *Co Petro* and similar cases in district courts as based on the principle that once it smells sulfur (Co Petro may have been a bucket shop), either agency may protect the investor. No such principle may be found in the '34 Act or the CEA, however. An instrument either is or is not a futures contract. If it is, the CFTC has jurisdiction; if it is not, the CFTC lacks jurisdiction; if the CFTC has jurisdiction, its power is exclusive. The SEC's position entails the proposition that if Co Petro Marketing Group, Inc. had approached the CFTC after losing in the Ninth Circuit and applied for permission to trade its gasoline contracts as futures, the CFTC would have had to say no, *on the ground that the contracts are not "contracts . . . for future delivery"* under the CEA. That can't be right.

Perhaps this point will be clearer if we ask what would have happened if the CBOT and CME had approached the CFTC in 1987 (before the Philadelphia Stock Exchange filed its proposal with the SEC) seeking permission to trade IPs. When we asked the SEC's Solicitor during oral argument



whether the CFTC could have granted such an application, he said yes—largely on the ground that granting the application would have introduced a new product with benefits for investors. When we persisted with the question whether the CFTC could grant the identical application filed by the CBOT and CME in 1989 (after the SEC's decision), the Solicitor said no, on the ground that by 1989 the SEC had asserted jurisdiction. Yet this principle of first-come-first-served finds no support in the '34 Act or the CEA. Either IPs are futures contracts or they aren't. If they are futures contracts, then the CFTC could have approved their trading in 1987 (as the Solicitor agreed); if IPs were futures in 1987, they are futures today, and the CFTC still may approve their trading. But if the CFTC may approve their trading because they are futures contracts, then the CFTC's jurisdiction is exclusive.

Doubtless such a decision gives the futures markets the opportunity to block competition from an innovative financial product. The SEC's order, and its brief in this court, casts much of the argument in the form: "The IP is a desirable product; the futures markets have not proposed to trade IPs; if IPs are futures then the CFTC's jurisdiction is exclusive and IPs won't exist, which would be regrettable; therefore IPs are not futures." Everything works until the "therefore". Whether IPs are futures can't depend on who first proposed to trade them, or on whether anyone does. We doubt the premise of the SEC's argument as well as its conclusion, for *if* IPs are useful to investors, then someone will offer them—if not the CBOT and CME, then a market in New York, or Kansas City, or Tokyo. The CBOT and CME will be compelled to follow or they will lose business. There are too many futures exchanges to suppose that a conspiracy could suppress a beneficial financial instrument, cf. *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 590 (1986). But whether or not a futures market will seek to trade a financial product does not change the nature of that product, and both the '34 Act and the CEA define coverage by the attributes of the *instrument* rather than by the identity of those who own or trade it. This is the central message of

*Landreth*, which at the SEC's urging rejected the "sale of business doctrine" precisely because that doctrine disregarded the characteristics of the financial instrument in order to go straight to the question whether certain persons needed the protection of the law—that is to say, whether coverage was a good idea.

From time to time, the Supreme Court has looked to the purposes of the '34 Act to define "securities", usually with a view to enlarging the definition. (The exception is *Marine Bank v. Weaver*, 455 U.S. 551 (1982).) With the SEC urging it on, the Court has drawn in orange groves covered by joint harvesting contracts, *W.J. Howey*, leaseholds in land near oil wells, *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), and other unusual instruments that have some (but far from all) attributes of conventional securities. Obviously the SEC does not ask us to abandon this approach—for itself. It demands, however, that we apply *strictissimi juris* to the CEA, to hold that only an instrument with *every* attribute of a conventional futures contract may be one. Why? If the interpretative approach is proper for the securities act, it is no less proper for the futures acts. It has been employed under both statutes—not only in *Co Petro* but also in redefining futures contracts to omit the delivery obligation. Recall the statutory scope of the CEA: contracts "for future delivery". Commodity futures contracts may be settled by delivery; financial futures contracts are settled exclusively in cash. One might have thought the prospect of "future delivery" the *sine qua non* of a "futures" contract. Yet no one, not even the SEC, doubts that a contract may be a futures contract even though it provides for cash settlement. If delivery is not essential, then the "traditional" elements of futures contracts are not invariable ingredients of the CFTC's jurisdiction.

Perhaps the SEC wants us to put a thumb on the scales, enlarging the category "securities" while shrinking the category "futures" because of the exclusivity clauses in the CEA: if both categories expand, then the SEC's jurisdiction shrinks. We do not conceive it our function, however, to invent coun-



terweights to statutes; judges should be interpreters rather than sappers and miners. As we said in *GNMA Options*, 677 F.2d at 1161, "[o]ur task should not reflect a value judgment as to which of the competing agencies is best equipped to regulate these [products]."

To the extent instrumental arguments influence the coverage of the laws, they do not necessarily cut for the SEC. The futures markets' reply brief invites us to imagine a "Wheat Index Participation" (WIP) having the same characteristics as the IP except that it is based on an index of wheat prices rather than of stock prices. The buyer would pay cash for the WIP and be able to trade it freely; on a date identical to the expiry of the wheat futures contracts, the writer could be required to pay cash measured by the value of the wheat index. According to the SEC, such an instrument would not be a futures contract because it would lack both futurity and bilateralism (and we would agree on the latter point). So the CFTC could not allow it to be traded, no matter how valuable participants in the market might find it. On the other hand, the WIP certainly would not be "stock" and probably would not meet the criteria for being a "security" of any kind. So the SEC could not allow it to be traded on stock exchanges (anyway, the WIP would be a duck out of water on the AMEX!). We could escape from such silliness by reaching the logical conclusion that a WIP would be a futures contract. Yet if the WIP is a futures contract, it is hard to avoid the conclusion that the IP is one, too.

The petition for review in No. 89-1538 is dismissed for want of jurisdiction. The Investment Company Institute's petition, No. 89-2012, presents questions that we need not reach in light of our disposition of the futures markets' claims. On petition Nos. 89-1763 and 89-1786, the SEC's orders approving the applications of the stock exchanges and the OCC are set aside.

A true copy:

Teste:

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*Clerk of the United States  
Court of Appeals for the  
Seventh Circuit*

APPENDIX D

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

CHICAGO, ILLINOIS 60604

May 18, 1989

Before

Hon. WILLIAM J. BAUER, Chief Judge  
Hon. HARLINGTON WOOD, JR., Circuit Judge  
Hon. JOHN L. COFFEY, Circuit Judge

Nos. 89-1538, 89-1763 and 89-1786  
CHICAGO MERCANTILE EXCHANGE and  
BOARD OF TRADE OF THE CITY OF  
CHICAGO,

Petitioners,

vs.

SECURITIES AND EXCHANGE  
COMMISSION,  
Respondent,

and

PHILADELPHIA STOCK EXCHANGE, INC.,  
OPTIONS CLEARING CORPORATION,  
AMERICAN STOCK EXCHANGE, INC., and  
CHICAGO BOARD OPTIONS  
EXCHANGE, INC.,  
Intervening Respondents.

Petitions for  
Review of an  
Order of the  
Securities and  
Exchange  
Commission

No. 89-2012  
INVESTMENT COMPANY INSTITUTE,  
Petitioner,

vs.

SECURITIES AND EXCHANGE  
COMMISSION,  
Respondent.

This matter comes before the court for its consideration of the following documents:

1. "PETITIONERS' MOTION FOR A STAY" filed herein on May 12, 1989, by counsel for the petitioners.
2. "APPENDIX TO PETITIONERS' MOTION FOR A STAY" filed herein on May 12, 1989, by counsel for the petitioners.
3. "OPPOSITION OF THE SECURITIES AND EXCHANGE COMMISSION TO PETITIONERS' MOTION FOR A STAY" filed herein on May 16, 1989, by counsel for the respondent.
4. "MEMORANDUM OF THE AMERICAN STOCK EXCHANGE IN SUPPORT OF ITS OPPOSITION TO PETITIONERS' APPLICATION FOR A STAY" filed herein on May 16, 1989, by counsel for the intervenor-respondent.
5. "MEMORANDUM OF LAW OF THE PHILADELPHIA STOCK EXCHANGE, INC. IN OPPOSITION TO PETITIONERS' MOTION FOR A STAY" filed herein on May 16, 1989, by counsel for the intervening respondent.
6. "AFFIDAVIT IN OPPOSITION TO PETITIONERS' MOTION FOR A STAY OF FINAL ORDERS OF THE SECURITIES AND EXCHANGE COMMISSION" filed herein on May 16, 1989, by counsel for the intervening respondent.
7. "MEMORANDUM OF THE OPTIONS CLEARING CORPORATION IN OPPOSITION TO PETITIONERS' MOTION FOR A STAY" filed herein on May 16, 1989, by counsel for the intervening respondent.
8. "MOTION TO CONSOLIDATE" filed herein on May 16, 1989, by counsel for Investment Company Institute.

9. "MOTION OF PETITIONER INVESTMENT COMPANY INSTITUTE FOR A STAY PENDING JUDICIAL REVIEW" filed herein on May 16, 1989, by counsel for the petitioner, Investment Company Institute.
10. "PETITIONERS' MOTION FOR LEAVE TO FILE COMMODITY FUTURES TRADING COMMISSION REPORT TO SENATE AGRICULTURE COMMITTEE AS ADDITIONAL AUTHORITY IN SUPPORT OF MOTION FOR STAY" filed herein on May 16, 1989, by counsel for the petitioners.
11. "MEMORANDUM OF THE PHILADELPHIA STOCK EXCHANGE, INC. IN OPPOSITION TO PETITIONERS' MOTION TO INTRODUCE ADDITIONAL AUTHORITY IN SUPPORT OF THEIR MOTION FOR A STAY" filed herein on May 17, 1989, by counsel for the intervening respondent.
12. "INTERVENOR AMERICAN STOCK EXCHANGE'S MEMORANDUM IN OPPOSITION TO MOTION OF PETITIONERS' TO EXPAND ADMINISTRATIVE RECORD" filed herein on May 17, 1989, by counsel for the intervening respondent.

On consideration thereof,

IT IS ORDERED that PETITIONERS' MOTION FOR A STAY and MOTION OF PETITIONER INVESTMENT COMPANY INSTITUTE FOR A STAY PENDING JUDICIAL REVIEW are DENIED.

IT IS FURTHER ORDERED that the MOTION TO CONSOLIDATE is GRANTED and these appeals are CONSOLIDATED for purposes of briefing, argument and disposition. The court further orders that briefing and argument will be expedited as follows:

1. Petitioners and Respondent/Intervenor-Respondents' opening briefs shall be due on or before 3:00 p.m., Wednesday, May 31, 1989.



2. Petitioners' and Respondent/Intervenor-Respondents' reply briefs shall be due on or before 5:00 p.m. Monday, June 5, 1989.

The parties are advised that neither Federal Rule of Appellate Procedure 25(a) nor Federal Rule of Appellate Procedure 26(c) will apply to these consolidated appeals. Oral argument will be held on Friday, June 9, 1989.

Finally, IT IS ORDERED that PETITIONERS' MOTION FOR LEAVE TO FILE COMMODITY FUTURES TRADING COMMISSION REPORT TO SENATE AGRICULTURE COMMITTEE AS ADDITIONAL AUTHORITY IN SUPPORT OF THEIR MOTION FOR A STAY, the MEMORANDUM OF THE PHILADELPHIA STOCK EXCHANGE, INC., IN OPPOSITION TO PETITIONERS' MOTION TO INTRODUCE ADDITIONAL AUTHORITY IN SUPPORT OF THEIR MOTION FOR A STAY and the INTERVENOR AMERICAN STOCK EXCHANGE'S MEMORANDUM IN OPPOSITION TO MOTION OF PETITIONERS TO EXPAND ADMINISTRATIVE RECORD will be taken with the case. The clerk of the court shall distribute a copy of this order along with copies of PETITIONERS' MOTION FOR LEAVE TO FILE COMMODITY FUTURES TRADING COMMISSION REPORT TO SENATE AGRICULTURE COMMITTEE AS ADDITIONAL AUTHORITY IN SUPPORT OF MOTION FOR STAY, the MEMORANDUM OF THE PHILADELPHIA STOCK EXCHANGE, INC. IN OPPOSITION TO PETITIONERS' MOTION TO INTRODUCE ADDITIONAL AUTHORITY IN SUPPORT OF THEIR MOTION FOR A STAY and the INTERVENOR AMERICAN STOCK EXCHANGE'S MEMORANDUM IN OPPOSITION TO MOTION OF PETITIONERS TO EXPAND ADMINISTRATIVE RECORD to the panel assigned to hear the merits of these consolidated appeals.

\* Counsel for all parties have been notified by telephone.

The parties are encouraged to adopt briefs, or parts of briefs, of other parties where appropriate to avoid duplication of arguments. Duplicative briefing will be stricken and may result in sanctions.

**APPENDIX E**  
**IN THE**  
**UNITED STATES COURT OF APPEALS**  
**FOR THE THIRD CIRCUIT**

\_\_\_\_\_  
**No. 89-3315**  
\_\_\_\_\_

INVESTMENT COMPANY INSTITUTE,  
Petitioner,  
v.  
SECURITIES AND EXCHANGE COMMISSION,  
Respondent.

**PETITION FOR REVIEW**

The Investment Company Institute (the "Institute") hereby petitions the Court to review, suspend and set aside two Orders issued by the Securities and Exchange Commission ("SEC") on April 11, 1989. The SEC Orders approved (1) proposed rule changes to permit the listing and trading of "stock-index participation" by the Philadelphia Stock Exchange, Inc. ("PHLX") (SEC File No. SR-PHLX-88-7), the American Stock Exchange, Inc. ("AMEX") (SEC File No. SR-AMEX-88-10) and the Chicago Board Options Exchange, Inc. ("CBOE") (SEC File No. SR-CBOE-88-09) (collectively referred to as the "Exchanges"), *see* Securities Exchange Act Release 26709 (April 11, 1989) ("Exchange Order"); and (2) proposed rule changes to enable the issuance, clearance and settlement of such stock-index participation by the Options Clearing Corporation ("OCC") (SEC File No. SR-OCC-88-2), *see* Securities Exchange Act Release 26713 (April 11, 1989) ("OCC Order"). Copies of the Exchange Order and OCC Order (collectively referred to as the "Orders") are annexed hereto as Exhibits A and B respectively.

## JURISDICTIONAL STATEMENT

This Petition for Review is filed pursuant to Section 25(a)(1) of the Securities Exchange Act, 15 U.S.C. § 78y(a)(1), which permits an aggrieved person to petition for review of an SEC order within sixty days of the entry of that order, and in accordance with Rule 15 of the Federal Rules of Appellate Procedure. This petition is timely filed within the required sixty-day period with respect to both the Exchange Order and the OCC Order. Venue is proper in this Circuit under Section 25(a)(1) of the Securities Exchange Act, 15 U.S.C. § 78y(a)(1), because the Institute is incorporated in the State of Delaware and therefore "resides" in this Circuit.

## BASIS OF PETITION

The SEC's Exchange Order and OCC Order must each be set aside in whole as contrary to and in violation of law because the Orders permit the Exchanges and the OCC to create and operate investment companies which are subject to the requirements of the Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.* (the "Act"), but which are not registered as such with the SEC. Therefore, the Exchanges and the OCC are not in compliance with the Act's provisions and have not been lawfully exempted from the provisions of the Act.

## TRANSFER TO SEVENTH CIRCUIT

On April 12, 1989, the Chicago Mercantile Exchange ("CME") and the Board of Trade of the City of Chicago ("CBOT") filed a Petition for Review of the Exchange Order in the United States Court of Appeals for the Seventh Circuit, *Chicago Mercantile Exchange and the Board of Trade of the City of Chicago v. Securities and Exchange Commission*, No. 89-1763 (7th Cir.), and on April 17, 1989, the CME

and CBOT filed a Petition for Review of the OCC Order in the same court, *Chicago Mercantile Exchange and the Board of Trade of the City of Chicago v. Securities and Exchange Commission*, No. 89-1786 (7th Cir.). Copies of these Petitions for Review are annexed hereto as Exhibits C and D respectively.<sup>1</sup> These petitions for review were the first petitions filed with respect to both the Exchange Order and the OCC Order, and upon information and belief, are the only other petitions for review that have been filed in any court with respect to the Exchange Order the the OCC Order. Upon information and belief, the SEC received copies of these petitions for review within ten days after the issuance of the Exchange Order and the OCC Order in accordance with the provisions of 28 U.S.C. § 2112(a)(1).

Section 28 U.S.C. § 2112(a)(1) provides that:

If within ten days after issuance of the order the agency, board, commission, or officer concerned receives, from the persons instituting the proceedings, the petition for review with respect to proceedings in at least two courts of appeals, the agency, board, commission, or officer shall proceed in accordance with paragraph (3) of this subsection. If within ten days after the issuance of the order the agency, board, commission, or officer concerned receives, from the persons instituting the proceedings, the petition for review with respect to proceedings in only one court of appeals, the agency, board, commission, or officer shall file the record in that court notwithstanding the institution in any other court of appeals of proceedings for review of that order. In all other cases in which proceedings have been instituted in two or more courts of appeals with respect to the same order, the agency, board, commission,

<sup>1</sup> The Court of Appeals for the Seventh Circuit subsequently ordered the consolidation of these two cases into *Chicago Mercantile Exchange & the Board of Trade of the City of Chicago v. Securities and Exchange Commission*, No. 89-1538 (7th Cir.).



or officer concerned shall file the record in the court in which proceedings with respect to the order were first instituted.

28 U.S.C. § 2112(a)(1).

The SEC issued both the Exchange Order and the OCC Order on April 11, 1989, and the ten-day period set forth in 28 U.S.C. § 2112(a)(1) thus expired on April 21, 1989. Thus, the instant Petition for Review was not filed within the ten-day period set forth in 28 U.S.C. § 2112(a)(1). As a result, the SEC is required, under 28 U.S.C. § 2112(a)(1), to file the record of proceedings underlying both the Exchange Order and the OCC Order in the United States Court of Appeals for the Seventh Circuit.

28 U.S.C. § 2112(a)(5) in turn requires that the instant Petition for Review be transferred to the Seventh Circuit. 28 U.S.C. § 2112(a)(5) directs that "[a]ll courts in which proceedings are instituted with respect to the same order, other than the court in which the record is filed pursuant to this subsection, shall transfer those proceedings to the court in which the record is so filed. . . ." 28 U.S.C. § 2112(a)(5). Because the instant petition seeks review of the same Orders as to which the SEC must file the record of proceedings in the United States Court of Appeals for the Seventh Circuit, *see* 28 U.S.C. § 2112(a)(1), 28 U.S.C. § 2112(a)(5) requires this Court to transfer the instant Petition for Review to that Circuit.

On May 12, 1989, the SEC denied applications for a stay pending judicial review submitted by the CME and CBOT, and separately by the Institute. *See* Securities Exchange Act Release No. 26811 (May 12, 1989). Upon information and belief, the CME and CBOT have filed a motion for a stay pending judicial review in the United States Court of Appeals for the Seventh Circuit. The Institute also intends to file a Motion for a Stay Pending Judicial Review. In the interests of justice and judicial economy, the Institute believes that its Motion should be filed in the United States Court of Appeals for the Seventh Circuit. Thus, the Institute respectfully re-

quests that this Court transfer the instant Petition for Review to that Circuit on an expedited basis.<sup>2</sup>

<sup>2</sup> On March 14, 1989, the SEC, at an open meeting, orally, "approved in principle," the proposed rule changes formally approved by the Orders. The CME and CBOT immediately filed a Petition for Review of the SEC's decision in the United States Court of Appeals for the Seventh Circuit. *Chicago Mercantile Exchange and the Board of Trade of the City of Chicago v. Securities and Exchange Commission*, No. 89-1538 (7th Cir.). A copy of this Petition for Review is annexed hereto as Exhibit E. The SEC moved to dismiss this action taking the position that the SEC's oral decision did not constitute the agency's final order. Motion of the Securities and Exchange Commission to Dismiss Petition for Review, *Chicago Mercantile Exchange and the Board of Trade of the City of Chicago v. Securities and Exchange Commission*, No. 1538 (7th Cir.) (March 20, 1989). The Exchanges have not disputed the SEC's position. In the event that the Court determines, for reasons that the Institute cannot foresee, to dismiss the Petitions for Review filed in *Chicago Mercantile Exchange and the Board of Trade of the City of Chicago v. Securities and Exchange Commission*, Nos. 89-1763 and 89-1786 (7th Cir.), and to conduct further proceedings on the SEC's oral decision in *Chicago Mercantile Exchange and the Board of Trade of the City of Chicago v. Securities and Exchange Commission*, No. 89-1538 (7th Cir.), the Institute respectfully requests that this Petition for Review be deemed to seek review of the oral decision of the SEC announced March 14, 1989. The Institute notes that, in such event, this petition is timely filed within the required sixty-day period following the SEC's March 14, 1989, oral decision.

Respectfully submitted,

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Dated: May 12, 1989

**APPENDIX F**

**SECURITIES AND EXCHANGE COMMISSION**

(Release No. 34-26709; File Nos. SR-Phlx-88-07;  
SR-Amex-88-10; SR-CBOE-88-09)

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; American Stock Exchange, Inc.; Chicago Board Options Exchange, Inc.; Order Approving Proposed Rule Changes Relating to the Listing and Trading of Index Participations

*I. Introduction*

On February 29, April 18, and May 26, 1988, the Philadelphia Stock Exchange, Inc. ("Phlx"), the American Stock Exchange, Inc. ("Amex"), and the Chicago Board Options Exchange, Inc. ("CBOE") (collectively "exchanges"), respectively, submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> proposed rule changes to list for trading market basket products designated as index participations ("IPs"). The proposed rule changes were noticed in Securities Exchange Act Release Nos. 25495 (March 23, 1988), 53 FR 10311; 25664 (May 5, 1988), 53 FR 16805; and 25799 (June 13, 1988), 53 FR 22754. The exchanges subsequently submitted amendments to their proposed rule changes.<sup>3</sup> The Commission received 25 comment letters relating to the proposed rule changes.<sup>4</sup>

<sup>1</sup> 15 U.S.C. § 78s(b)(1) (1982).

<sup>2</sup> 17 C.F.R. § 240.19b-4 (1988).

<sup>3</sup> These Amendments have been noticed for public comment in the *Federal Register*. See notes 6, 7, 9, 10, 14, and 17 *infra*.

<sup>4</sup> See notes 22-28 and 30-31, *infra* and accompanying text.



## II. Background and Description of the Products

### A. Terms of the Contracts

An IP is a present interest in the current value of a portfolio of stocks. IPs are of indefinite duration, and entitle holders to cash payments equivalent to a proportionate share of any regular cash dividends paid on the component stocks of the underlying equity portfolio. Investors buying and selling IPs can realize profits or limit losses on their investment by entering into an offsetting sale or purchase of an IP in a closing transaction and thereby receive or make payment of the difference between the cost of the opening and closing transactions. Alternatively, investors purchasing IPs may elect instead to realize profits or limit losses on their investment through exercising a cash-out privilege<sup>5</sup> which is available, depending on the IP, on a daily, quarterly, or a semi-annual basis.

The dates on which IPs purchasers may obtain the full index value upon exercise of the cash-out privilege are designated as cash-out times. Excluding the Phlx's daily cash-out alternative, the cash-out time for each quarter or semi-annual period, depending on the IP, will be determined and made public by each Exchange before the beginning of such period.

The Phlx IP, called the Cash Index Participation ("CIP"), permits holders to exercise the cash-out feature on a daily basis in addition to the designated quarterly cash-out time.<sup>6</sup>

<sup>5</sup> See discussion on p.6 *infra*.

<sup>6</sup> The CIP, when first proposed by the Phlx, provided for a quarterly cash-out only. Subsequently, on September 26 and October 11, 1988, the Phlx submitted Amendments Nos. 2 and 3, respectively to its proposed rule change. In general, these amendments would permit CIP holders to exercise the cash-out feature on a daily as well as quarterly basis. To exercise the daily cash-out feature an IP holder must submit notice of this exercise by 4:15 p.m. The IP holder would receive a cash payment equal to 99.5% of the index value as of the close of business the following day. The Phlx has tentatively determined to establish the quarterly cash-out time to

A CIP holder that exercises the cash-out feature on any day other than the designated quarterly cash-out time will receive 99.5% of the underlying portfolio's value. The Phlx notes that the .5% differential subtracted from the index value received by such CIP holders is a fee that reflects the substantial benefit to CIP holders of daily cash-out, and that CIP holders may avoid the discount by closing out their positions for cash in the market or by cashing out at a regular quarterly cash-out date. The Amex product is termed the Equity Index Participation ("EIP"). EIPs, as originally proposed by the Amex, enabled purchasers to exercise a cash-out privilege on a quarterly basis. On October 27, 1988, the Amex submitted an amendment to permit EIP holders to receive either cash or physical delivery of shares of the component stocks of the S&P 500 Index and the Major Market Index under specified circumstances.<sup>7</sup> More specifically, the holder of one or more delivery units<sup>8</sup> that has not chosen to exercise the cash-out privilege has the right to obtain on each delivery time, which coincides with the quarterly cash-out time, the physical delivery of the proportionate number of shares of each stock comprising the underlying index, subject to certain condi-

coincide with the expiration of the leading stock index futures contracts [i.e. the opening of trading on the third Friday of March, June, September, and December ("Expiration Friday")]. See Securities Exchange Act Release No. 26174 (October 13, 1988), 53 FR 40814.

<sup>7</sup> See Securities Exchange Act Release No. 26243 (November 2, 1988), 53 FR 45407.

<sup>8</sup> A delivery unit is defined as the minimum number, as specified by the Amex, of EIPs of a particular class that must be held in an individual account by a holder at the time of exercise of the delivery privilege, or that must be maintained as a short position in an equivalent account by a person who notifies OCC of a desire to make physical delivery of securities to a holder if assigned an exercise. The Amex has tentatively established the delivery unit as 50,000 EIPs per unit for the S&P 500 Index and 25,000 EIPs per unit for the XMI. The Amex believes that permitting physical delivery of units below these levels would be impractical because of the minute number of shares of individual stocks that would be deliverable. If the Amex intends to modify the minimum number of EIPs that constitute a delivery unit, then the exchange must submit a separate proposed rule change for Commission approval.

tions. A delivery fee established by the Amex will be charged to EIP holders taking physical delivery of the component stocks.

Under the Amex proposal, exercise notices requesting physical delivery of one or more delivery units will be assigned first, on a random basis, to those short EIP positions that have notified the Options Clearing Corporation ("OCC") of a desire to make physical delivery. If the number of delivery units for which holders have requested physical delivery exceeds the number of units made available for delivery by persons with short EIP positions, then an Amex-designated physical delivery facilitator will assume responsibility for delivering the physical shares with respect to such excess number of units.<sup>9</sup>

The CBOE product, called the Value of Index Participation ("VIP"), differs from both the Phlx CIP and the Amex EIP in that it allows VIP sellers, as well as purchasers, to exercise a cash-out privilege on a semi-annual basis. A person with a short VIP position desiring to exercise the cash-out privilege originally was required to pay a premium of 1% of the index's value. The CBOE eliminated this charge, however, in an amendment filed on November 1, 1988.<sup>10</sup> The Exchange believes that the existence of a cash-out privilege for holders of both long and short positions will cause the price

<sup>9</sup> The Amex's Amendment No. 2 to its EIP filing noted that the physical delivery facilitator could deliver shares out of inventory, buy shares at the opening on the cash-out date, or borrow shares. However, in order to ameliorate any concerns regarding the facilitator's advance knowledge of physical delivery unit imbalances, the Amex submitted an additional amendment under which the facilitator may satisfy such imbalances only by delivering component shares purchased at the opening on the cash-out date. This facilitator will be compensated out of proceeds received from shorts who have been assigned exercise notices. Initially, the Amex contemplates designating only one facilitator per EIP class and notes the facilitator may be the specialist unit for that class of EIPs. See Securities Exchange Act Release No. 26355 (December 13, 1988), 53 FR 51181.

<sup>10</sup> See Securities Exchange Act Release No. 26257 (November 7, 1988), 53 FR 45833. This amendment also changed the cash-out feature from a quarterly to a semi-annual cycle.

of VIPs to trade more closely to the value of the underlying portfolio because it will allow a hedged short VIP holder an alternative to reversing his position by purchasing the VIP at the current market price and selling the underlying equities.

Notice of exercise of the IP cash-out privilege must be provided by an IP purchaser on or before a time specified and made public by the Exchange on which the IP is traded. The exchanges have determined to establish and make public the cut-off time for the submission of notices of exercise of an IP cash-out privilege before the beginning of each quarterly or semi-annual cash-out time. At the present time, the exchanges have established an exercise cut-off time of the close of trading on the day before the quarterly or semi-annual cash-out time (i.e. 4:15 p.m. on the Thursday before the quarterly or semi-annual cash-out time).<sup>11</sup> An exercise notice may be tendered to the OCC only by the OCC clearing member in whose account the IP is carried. Upon exercise of the quarterly or semi-annual cash-out privilege an IP purchaser may obtain at the cash-out time the IP index value based on the opening trades of the portfolio's component stocks on the next day.<sup>12</sup>

Pursuant to the exchanges' proposed rules, each member organization will establish fixed procedures for the allocation of IP exercise notices assigned to a short (or long also in the case of CBOE VIPs) position in IPs in such member organization's customers' accounts. Such allocation shall be made on either a "first-in, first-out" basis, automated random selection basis that has been approved by the exchanges, or on a manual random selection basis. Each member organization will inform its customers in writing of the method it

<sup>11</sup> If the exchanges intend to modify the exercise cut-off time they must submit separate proposed rule changes for Commission approval pursuant to Section 19(b)(2).

<sup>12</sup> A CIP holder exercising the daily cash-out privilege on a day other than the quarterly cash-out time receives the value of the portfolio at the close of the next trading day, less the .5 percent exercise fee described above.



uses to allocate exercise notices to its customers' accounts, explaining its manner of operation and the consequences of that system.

Pursuant to the exchanges' proposed rules, all bids and offers made on the trading floor for IPs will be deemed to be for one unit of trading unless a specified greater number of IPs is expressed. A bid or offer for more than a unit of trading of IPs will be deemed to be for the amount thereof or a smaller number of units of trading of IPs. The unit of trading in IPs shall be 100 IPs unless otherwise designated by the Exchange.<sup>13</sup>

The exchanges have reserved the right, in the event of extreme IP trading inactivity or under exceptional circumstances, to require that purchasers and sellers settle their IP contracts at the closing index value determined by a designated cash-out time, upon one year's prior notice to the public.

## B. *Portfolios Underlying the Proposed Index Participations*

### 1. *Composition, Calculation and Adjustment*

The exchanges contemplate trading IPs on a variety of underlying portfolios, most of which are relied upon as well-established and widely-disseminated market indicators or market segment indicators, and some of which are new. The Phlx has designated two underlying portfolios for CIP trading: a broad-based portfolio designed by the Exchange ("Blue Chip" Index) and the Standard & Poors 500 ("S&P" 500) portfolio.<sup>14</sup>

<sup>13</sup> If the exchanges intend to modify the unit of trading from 100 IPs they must submit separate proposed rule changes for Commission approval.

<sup>14</sup> Originally, the Phlx proposed trading a Stock Market CIP that was based on a 100 stock portfolio developed by the Exchange and was designed to track closely with the S&P 500. On August 23, 1988, the Phlx submitted Amendment No. 1 to the filing in which it withdrew its proposed Stock Market CIP and indicated that it would trade a S&P 500 CIP in its

The Blue Chip CIP is an IP based on a price-weighted portfolio composed of 25 highly capitalized listed common stock issues representing primarily industrial corporations, and which is designed to replicate the performance of the Dow Jones Industrial Average ("DJIA"). Each Blue Chip CIP will represent  $\frac{1}{100}$  (the multiplier) times the value of the portfolio, and each S&P 500 CIP<sup>15</sup> will represent  $\frac{1}{10}$  (the multiplier) times the value of the portfolio. The standard unit of trading in such CIPs will be 100 CIPs, and bids and offers will be expressed in decimals. The Exchange expects to establish a starting Blue Chip CIP portfolio value of approximately 2000, so that each Blue Chip CIP would be priced at approximately \$20.00, and each Blue Chip CIP trading unit would be priced at approximately \$2,000. The value of the portfolio will be adjusted to account for stock splits, stock dividends, and extraordinary cash dividends. The value of the portfolio will not be adjusted for regular cash dividends paid out to CIP holders. If the character of any stock in the portfolio materially and substantially changes on the account of delisting, merger, acquisition, or otherwise, the Exchange will replace such stock with another stock which possesses similar characteristics so as to retain the integrity and representativeness of the portfolio.

The Amex EIPs will be based on the Major Market Index ("XMI")<sup>16</sup> and the S&P 500.<sup>17</sup> The XMI is a broad-based

place. See Securities Exchange Act Release No. 26058 (September 2, 1988), 53 FR 35247.

<sup>15</sup> See Securities Exchange Act Release No. 19907 (June 24, 1983), 48 FR 30814 for a detailed description of the S&P 500 Stock Index. As of December 6, 1988, the closing index value for the S&P 500 was 277.58. Thus, each S&P 500 CIP would be priced at \$27.75, and each S&P 500 trading unit would be priced at \$2,775.

<sup>16</sup> See Securities Exchange Act Release Nos. 19610 (March 17, 1983), 48 FR 12486; 19709 (April 27, 1983), 48 FR 20179 for a detailed description of the XMI.

<sup>17</sup> The Exchange originally proposed to trade EIPs on the XMI and the Institutional Index ("XII"). On July 21, 1988, however, the Exchange submitted to the Commission Amendment No. 1 to File No. SR-Amex-88-10 to trade EIPs on the S&P 500 rather than on the XII. See Securities

price-weighted portfolio developed by the Amex, and is comprised of 20 highly capitalized issuers. Each XMI EIP will represent  $\frac{1}{10}$  (the multiplier) times the portfolio's value,<sup>18</sup> and the standard unit of trading in such EIPs will be 100 EIPs. Bids and offers for EIPs will be quoted in decimals.

The CBOE VIPs are based on the capitalization-weighted CBOE 50 and CBOE 250 portfolios<sup>19</sup> developed and maintained by the Exchange, and the S&P 500 Index, calculated and maintained by Standard and Poor's Corporation. Each CBOE VIP will represent  $\frac{1}{10}$  (the Index multiplier) times the Index value,<sup>20</sup> and the standard unit of trading will be 100 VIPs. Bids and offers for VIPs will be quoted in fractions of  $\frac{1}{4}$  of a point.

## 2. Publication

Publication of the values underlying the IPs will occur at two levels.<sup>21</sup> First, the exchanges will make public the component portfolios they use for calculating the value of their participations. This is necessary to provide market professionals, institutions, and other public investors a basis for relating the value of these participations to their own stock positions, and for maximizing the utility of the participations. The Phlx, Amex, and CBOE currently publicize the means

Exchange Act Release No. 25942 (July 25, 1988), 53 FR 28929.

<sup>18</sup> As of December 6, 1988 the closing index value for the XMI was approximately 423. Thus, each XMI EIP would be priced at \$42.30, and each XMI EIP trading unit would be priced at \$4,230.

<sup>19</sup> See Letter from Jonathan G. Katz, Secretary, SEC to Dr. Paula Tosini, Director, Division of Economic Analysis, CFTC, dated April 22, 1988 for a detailed description of both the underlying CBOE 50 and CBOE 250 portfolios.

<sup>20</sup> As of December 6, 1988 the closing value for the CBOE 250 was approximately 248. Thus, each CBOE 250 VIP would be priced at \$24.80, and each CBOE VIP trading unit would be priced at \$2,480.

<sup>21</sup> Publication and dissemination of the values of the portfolios underlying IPs will help to ensure the maintenance of a fair and orderly market in the product consistent with the goals of Section 11A(a)(1) of the Act and to reduce the possibility of fraudulent or manipulative trading involving the IPs. See 15 U.S.C. § 78f(b)(5) (1982).

by which they compute values of the portfolios underlying their participations (*i.e.* summation of share prices divided by a specific divisor, times the multiplier).

Second, in addition to the real-time computation of underlying portfolio values that will be the subject of index participation trading, those values will be widely disseminated. Because products related to the portfolios underlying the Amex EIP, the CBOE VIP, and the Phlx S&P 500 CIP previously have been approved for trading, those values are already widely disseminated. Additionally, the Phlx has retained Bridge Data, Inc. to compute and perform all necessary maintenance of the Blue Chip CIP. Pursuant to Phlx Rule 1003B, updated underlying portfolio values will be disseminated and displayed by means of primary market prints reported over the Consolidated Last Sale Reporting System and the facilities of the Options Price Reporting Authority. The value of the underlying portfolios will also be available on broker-dealer interrogation devices to subscribers of the CIPs information.

## III. Comments Received

The Commission received 25 comment letters in response to its requests for comments on the Phlx, Amex, and CBOE proposed rule changes. Fifteen of the twenty-five comment letters were submitted on behalf of the Commodity Futures Trading Commission ("CFTC"), the Chicago Board of Trade ("CBT"), or the Chicago Mercantile Exchange ("CME"). These letters expressed the belief that the IPs are futures, and therefore that the Commission lacks jurisdiction to approve the proposed rule changes.<sup>22</sup> In response to these

<sup>22</sup> See Letters to Jonathan G. Katz, Secretary, SEC, from Jean A. Webb, Secretary, CFTC (April 29 ("1st CFTC Letter"), June 1, and July 8, 1988); Thomas R. Donovan, President and Chief Executive Officer, CBT (April 20 ("1st CBT Letter"), June 1, July 8, and November 30, 1988); William Brodsky, President and Chief Executive Officer, CME (April 20 ("1st CME Letter"), May 18, and November 29, 1988); Phillip Stern and



futures industry comment letters the Commission received letters from the Phlx and CBOE, and a comment letter from the Amex, which included opinions of their respective legal counsels, stating that IPs are securities and therefore subject to SEC jurisdiction.<sup>23</sup> Two letters came from the Phlx and Amex that addressed issues related to timing of Commission action on IPs.<sup>24</sup> The Commission also received a letter from the Phlx commenting on Amex Amendment No. 2 to its EIP filing providing for physical delivery,<sup>25</sup> a letter from the Amex responding to this Phlx comment letter,<sup>26</sup> and letters from three investors, two expressing support for immediate approval of CIPs<sup>27</sup> and one suggesting that EIPs are an unnecessary investment tool.<sup>28</sup> In addition, the Commission received a letter from the Investment Company Institute ("ICI") arguing that IPs are investment company shares and thus must receive relief from the Investment Company Act of 1940<sup>29</sup> before they may be traded on a national securities

Jerrold Salzman, Attorneys, Freeman, Freeman & Salzman on behalf of the CME (August 2, November 7 ("5th CME Letter"), and December 1, 1988 and March 2, 1989). See also Letter from Jean A. Webb, Secretary, CFTC, to Shirley E. Hollis, Assistant Secretary, SEC, dated December 13, 1988.

<sup>23</sup> See note 34 *infra*.

<sup>24</sup> See Letters to Jonathan G. Katz, Secretary, SEC, from Nicholas A. Giordano, President, Phlx (June 29, 1988) ("Phlx letter"); Kenneth R. Liebler, President and Chief Operating Officer, Amex (July 27, 1988) ("Amex letter").

<sup>25</sup> See Letter from Nicholas A. Giordano, President, Phlx to Jonathan G. Katz, Secretary, SEC, dated November 23, 1988.

<sup>26</sup> See Letter from Gordon L. Nash, Senior Executive Vice President, Legal and Regulatory Affairs, Amex to Jonathan G. Katz, Secretary, SEC, dated February 10, 1989.

<sup>27</sup> See Letter from Dennis Weidenbenner to Richard G. Ketchum, Director, Division of Market Regulation, SEC, dated September 29, 1988; Letter from William A. Dodd, Jr. to David Ruder, Chairman, SEC, dated February 24, 1989.

<sup>28</sup> See Letter from K. Thomas Shipley, Executive Vice President, Charter Investment Group, Inc., to David S. Ruder, Chairman, SEC, dated March 29, 1989.

<sup>29</sup> 15 U.S.C. §§ 80a-1 through 80a-52 (1982).

exchange.<sup>30</sup> Subsequent to the Commission's consideration of the proposed IPs during an open meeting on March 14, 1989, the Commission received a letter on behalf of the ICI arguing that the issuance and trading of IPs create investment companies. In particular, the ICI claimed that the individuals holding long IP positions and short IP positions each constitute an "issuer" under the statutory definition of that term because they are an "organized group of persons."<sup>31</sup>

### A. Futures Industry Letters

In general, the CFTC, the CBT, and the CME ("futures commentators") argue that the Commission lacks jurisdiction to authorize IP trading through approval of the Exchanges' proposed rule changes because an IP does not constitute a "security" as defined in Section 3(a)(10) of the Act.<sup>32</sup> In particular, the futures commentators argue that the economic function and purpose of IPs are characteristic of stock index futures rather than stock or index options, and that IPs are therefore subject to the exclusive jurisdiction of the CFTC pursuant to Section 2(a)(1)(B) of the Commodity Exchange Act ("CEA").

The futures commentators suggest several reasons to categorize IPs as stock index futures. First, they argue that both the purchaser and seller of an IP contract have entered into a transaction that may be cashed out at a future date at a price based upon the difference between the price established at the initiation of the contract and some undetermined future price. Second, with the exception of the Amex EIP, the IP contract provides for cash settlement only. Third, while an IP long is entitled to hold his position indefinitely, they argue

<sup>30</sup> See Letter from Matthew P. Fink, ICI, to Richard G. Ketchum, Director, Division of Market Regulation, SEC, dated December 19, 1988.

<sup>31</sup> See Letter from David M. Miles, Attorney, Fried, Frank, Harris, Shriver & Jacobson on behalf of the ICI, to David S. Ruder *et al.*, Chairman, SEC, dated March 31, 1989. The Commission, in its discretion, determined to consider this comment. 17 C.F.R. 202.6(b).

<sup>32</sup> 15 U.S.C. § 78(c)(1)(j) (1982).



that essentially the contract has a quarterly expiration—identical to the cycle now applicable for similar futures contracts—due to the quarterly cash-out feature. The futures commentators suggest that this feature is synonymous with an “undated futures market contract.” They suggest further that the outcome of effective competition will be that an IP long actually will pay a commission to “roll over” his position, at the time he enters into an IP contract, in the form of higher IP prices. Fourth, there is no apparent option premium paid by an IP long.

The CME, specifically, suggests that, although IPs include two features that may not be immediately recognized as standard features of futures contracts, those features serve the economic equivalent of futures characteristics.<sup>33</sup> First, the short will be required to pay to the long cash payments equivalent to a proportionate share of any regular cash dividends paid on the component stocks of the underlying index. The CME suggests that the concept of a cash payment from the short to the long, related to measured or theoretical shrinkages in the value of the underlying product, is a feature also found in futures contracts. Second, IPs afford longs the right to select the time at which shorts will be compelled to make cash delivery. The CME notes that this is a standard feature of most physical commodity based futures contracts, and that a futures contract holder generally has a far wider range of options (e.g., the ability to control the exact date, time, and place of the delivery of the commodity to the long).

The Phlx, CBOE, and Amex (the “exchanges”) argue that IPs should be viewed as securities as defined in Section 3(a)(10) of the Act.<sup>34</sup> In general, the Phlx and CBOE base

<sup>33</sup> See 1st CME Letter at 2-3.

<sup>34</sup> See generally Letter from William W. Uchimoto, Acting General Counsel, Phlx, to Richard G. Ketchum, Director, Market Regulation, SEC, dated May 24, 1988, enclosing opinion of Cadwalader, Wickersham and Taft, Phlx legal counsel, regarding SEC jurisdiction over IPs (“Cadwalader Letter”); Letter from Nancy R. Crossman, First Vice President, Legal Services, CBOE to Howard Kramer, Assistant Director, Division of Mar-

their argument on *SEC v. C.M. Joiner Leasing Corp.*<sup>35</sup> in which the Supreme Court emphasized the economic function of instruments in determining whether they constituted securities.<sup>36</sup> Specifically, the Phlx argues that although IPs do not possess all of the familiar characteristics of common stock as described in *Landreth Timber Co. v. Landreth*<sup>37</sup> an IP does possess most of the characteristics of stock, and purchases and sales of an IP are intended to replicate the economic substance of purchases and sales of an equivalent amount of the underlying stocks.<sup>38</sup>

First, the exchanges argue that IPs entitle holders to receive on a quarterly basis cash payments equivalent to the regular cash dividends declared on the component stocks of the underlying index. Second, the Phlx argues that an IP purchaser will have the ability to pledge or hypothecate his interest in the IP. For example, as a typical provision of customer agreements with a brokerage firm, an investor normally will pledge or hypothecate his interest in the IP, including profits and dividends, as security to the broker for any indebtedness arising in connection with his account or any other indebtedness to the broker. Third, the Phlx argues that IPs will be freely transferable in exchange transactions; thus, IPs will be negotiable in the same sense as exchange-traded equities and equity and non-equity securities options. Fourth, the exchanges argue that IPs will have the capacity to appreciate in value as the securities comprising the underlying portfolio increase in value.

ket Regulation, SEC, dated September 9, 1988, enclosing opinion of Gardner, Carton and Douglas, CBOE legal counsel, regarding SEC jurisdiction over IPs; Letter from Edmund R. Schroeder, Attorney, Lord Day & Lord, Barrett Smith, Amex legal counsel, to Jonathan G. Katz, Secretary, SEC, dated January 13, 1989.

<sup>35</sup> 320 U.S. 344 (1943).

<sup>36</sup> *Joiner Leasing Corp.*, 320 U.S. at 350-51 (1943). The Amex argues that an IP is a security because it is: (1) a call or option on any security or group or index of securities; (2) a certificate of interest or participation in stock; and (3) a right to purchase stock.

<sup>37</sup> 471 U.S. 681, 686-87 (1985). See discussion on pp. 28-29 *infra*.

<sup>38</sup> See Cadwalader letter, *supra* note 34, at 5.

In addition, the Phlx and CBOE assert that, although the purchase and sale of an IP does not constitute the purchase and sale of the underlying shares of stock, the economic substance of transactions in the IP leads to the conclusion that the IP should be viewed as stock for purposes of the definition of security. An IP purchaser or seller will have similar risks and obligations as a person long or short stock. The Phlx notes further that, to the extent these risks and obligations differ from those associated with stock, they resemble a stock index option because of the availability of a cash-out privilege, and because IPs would be issued by the OCC rather than a corporation. Moreover, the Phlx argues that the cash settlement feature of IPs should not lead to the conclusion that IPs are more akin to stock index futures than to securities as defined under Section 3(a)(10) of the Act. The Phlx suggests that in amending the definition of the term "security" to include "any put, call, straddle, option, or privilege on any security . . . or group or index of securities (including any interest therein or based on the value thereof) . . ." Congress explicitly recognized that products which function economically as securities are themselves securities, although they are cash-settled based on the value of underlying securities or indexes.

The Phlx and CBOE argue that IPs are securities because, in addition to possessing the characteristics of stock, IPs may be classified as "an instrument commonly known as a security." In making this determination the Phlx and CBOE rely on the majority view in *Landreth* that the reasonable expectation of investors that they are purchasing securities subject to the securities laws is of particular significance in determining whether an instrument bearing only some of the traditional characteristics of a type of security enumerated in Section 3(a)(10) is a security.<sup>39</sup>

The exchanges suggest that, even if an IP may be considered a commodity under the CEA definition, it is not a "contract of sale for future delivery" for purposes of that

Act. In this regard, the exchanges argue that although IPs may possess certain elements characteristic of futures contracts [e.g., standardized terms and the ability of investors to realize profits or limit losses through entry into offsetting sales or purchases and payment of the difference between the purchase (sale) price and the price at which the closing transaction is effected] they lack the most significant element for CEA purposes—the element of futurity.

The exchanges assert that, unlike stock index futures contracts, a purchase or sale of an IP does not entail a commitment by an investor to buy or sell the value of the underlying index at some time in the future. The exchanges argue that a purchase or sale of the IP involves an actual purchase or sale of the current value of the underlying index, similar to an actual transfer of ownership of the underlying stocks.<sup>40</sup>

In addition, the exchanges note that IPs have other characteristics that differ from futures contracts. First, unlike futures contracts that are listed for trading in different contract months, IPs have a perpetual existence with no fixed expiration date. Second, the IP gives the purchaser a cash-out privilege and the right to receive on a quarterly basis cash payments equivalent to a proportionate share of any regular cash dividends paid on the component stocks of the underlying portfolio. Futures, on the other hand, require settlement upon expiration of the contract and do not grant the right to receive payment of dividends. Third, IPs are less highly leveraged than stock index futures because their proposed margin requirement is 50% of the IP value. In addition, the exchanges note that the IP margin represents a down payment on the purchase price, rather than earnest money or a performance bond, which is the function served by the much lower levels of margin applicable to stock index futures contracts.

<sup>40</sup> The exchanges note that when an IP is purchased 100% of the instrument's value must be paid. In this regard, even if an IP were margined, an IP purchaser would have to contribute 50% of the transaction's value and convince a lender to loan the remaining 50%.

<sup>39</sup> *Infra* note 46.



### B. Proprietary and Other Concerns

In two comment letters regarding Amex's proposed trading of EIPs, the Phlx alleges that the Amex appropriated the CIP design to create the EIP. The Amex filed its EIP proposal with the Commission shortly after the Phlx, and its original EIP design was virtually identical to the CIP design. The Phlx notes that it has expended a great deal of time, effort, and expense in designing and submitting this new product to the Commission for approval. For example, significant staff time and outside legal counsel fees have been spent in preparing the CIP to be traded. The Phlx believes that allowing the Amex to begin trading an identical product at the initiation of CIP trading would undercut the Phlx's efforts to develop new and innovative products such as CIPs. Further, the Phlx suggests that its CIP product constitutes protectable intellectual or creative work of pecuniary value and is therefore protected under common law principles and statutory law.<sup>41</sup> The Phlx argues both that a vested property right arises with respect to its CIP and that the Amex has infringed its CIP copyright by appropriating entire provisions constituting the vast preponderance of the Phlx's CIP contract specifications and trading rules and presenting them as Amex rules.

For these reasons, the Phlx argues that approval of the Amex's EIP proposal would be inconsistent with Section 6(b)(5), Section 6(b)(8), and Section 11A(a)(1)(C)(ii) of the Act. The Phlx believes that, at the least, it should be provided a 12 to 18 month head start in the introduction of its IP product. In addition to the proprietary product comments, the Phlx argues that the Amex proposal is deficient in discussing the side-by-side trading concerns that could arise

<sup>41</sup> See, e.g., *International News Service v. Associated Press*, 248 U.S. 215 (1918); *Standard & Poor's Corp. v. Commodity Exchange, Inc.*, 683 F.2d 704 (2d Cir. 1982); *Board of Trade of the City of Chicago v. Dow Jones & Co.*, 98 Ill.2d 109, 456 N.E.2d 84 (1983).

from EIP trading.<sup>42</sup> The Phlx suggests that, because Amex proposes to trade EIPs on the Amex's MMI, a portfolio upon which Amex currently lists and trades options, there exists the potential for significant time and place advantages and concomitant inside market information, as well as possible conflict of interest and manipulation concerns.

In response to Phlx's comments regarding Amex's EIPs proposal the Amex submitted a comment letter outlining four major rebuttals to the Phlx letter.<sup>43</sup> First, the Amex suggests that the Commission lacks the authority to adjudicate Phlx's property claims. In this regard, the Amex notes that there is no evidence that Congress intended to provide the Commission with the authority to adjudicate property interests among competing parties because Congress has enacted an elaborate statutory framework for the establishment, preservation, and protection of intellectual or creative works and established specific federal agencies (e.g., the U.S. Patent and Trade-

<sup>42</sup> The Phlx notes that the Amex proposes to trade an EIP on the XMI in addition to the XMI index option currently traded on the Amex floor. The Phlx alleges that the trading of an XMI EIP and XMI option should be prohibited because of informational advantages and potential manipulative schemes that could occur as a result of trading these two products on the same floor, side-by-side. The Commission previously has noted that the side-by-side trading of stocks and options on those stocks, while raising regulatory concerns, may be permitted provided adequate audit trail, surveillance information and regulatory safeguards are in place. The Commission has determined that any side-by-side trading concerns (e.g., informational advantages and potential manipulative schemes) are not present with regard to Amex's EIPs for several reasons. First, the Amex will not be trading an individual stock and an option on that individual stock side-by-side. Instead, the Amex will be trading an index option and the equivalent of a portfolio of stocks on its floor. Second, the 20 stocks that comprise the XMI, and therefore directly determine the index's value, have a primary market on the New York Stock Exchange ("NYSE") rather than the Amex. Consequently, any informational advantages associated with trading an XMI EIP on the Amex are minimal. Finally, the Commission is satisfied that existing audit trail data, surveillance information and regulatory safeguards are sufficient to allay any side-by-side trading concerns.

<sup>43</sup> *Supra* note 24.



mark Office and U.S. Copyright Office) to administer and enforce these laws. The Amex further notes that the Act provides, neither expressly nor implicitly, that competing property claims among self-regulatory organizations ("SROs") is a proper area of Commission consideration in determining whether to approve specific rule proposals.

Second, the Amex suggests that a Section 19(b) proceeding is inappropriate for adjudicating property rights because such a proceeding would involve the Commission in an exhaustive factual investigation including, but not limited to, a determination of which exchange actually developed the product. The Amex notes that it is prepared to document the fact that it has been actively working for several years on the development of a market basket security and has expended extensive time and resources in so doing.

Third, the Amex suggests that the Phlx CIP is legally protected by neither statutory nor common law principles. The Amex asserts that such a trading instrument is a concept, and thus an idea that can not be protected under federal statutory law. The Amex suggests that because it does not seek to utilize any underlying portfolio designed, calculated and disseminated by Phlx as a basis for EIPs trading, and because none of the cases cited in the Phlx letter suggested that duplication or imitation of the idea or the concept on which a commercial enterprise is based would constitute a misappropriation, the Amex has not misappropriated the Phlx product.

Fourth, the Amex suggests that the "fair competition" mandate of Section 11A(a)(C)(ii) of the Act does not authorize the Commission to grant exclusive franchises. The Amex notes that the cases cited by Phlx in support of its proprietary rights theory recognized that the freedom to imitate and duplicate is of vital importance in a free market economy. In addition, the Amex, citing the experiences of the options

markets,<sup>44</sup> argues that Phlx's contention that innovation and commitment to the development of new products will be stifled unless SROs are provided some protected property interest in ideas filed with the Commission is simply erroneous.

#### IV. Discussion

After careful consideration of the comments received, applicable statutory provisions, and relevant judicial and administrative decisions, the Commission concludes that IPs are securities within the definition of that term in the Act and are not contracts of sale for future delivery, and that therefore such products are subject to the jurisdiction of the Commission. In addition, the Commission concludes that the Phlx should not be provided either exclusive trading privileges over IPs or the opportunity to commence IPs trading in advance of other exchanges.

For these reasons and for additional reasons set forth below, the Commission finds that the proposed rule changes relating to the listing and trading of IPs are consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, in general, and the requirements of Section 6 and the rules and regulations thereunder, in particular.

##### A. Jurisdiction

IPs confer the present right to receive the current value of a portfolio of stocks, are of indefinite duration, and entitle holders to payments equivalent to regular cash dividends paid on the underlying stocks. For the reasons set forth below, the Commission concludes that IPs are securities as defined in the Act. Further, the Commission concludes that IPs are not

<sup>44</sup> The Amex, referring to several Commission releases, notes that the development of new options products has consistently been determined by the Commission not to provide any claim to exclusive trading rights, regardless of which SRO was responsible for initiating the design thereof, for expending funds, time and resources to promote the product, or being the first to file with the Commission.

futures contracts subject to regulation under the CEA, and that regulation of IPs as securities is consistent with the purposes underlying both the Act and the CEA.

### 1. *IPs are Securities*

The Commission concludes that each of the proposed IP products is a security within the definition of that term under Section 3(a)(10) of the Act. Congress intended that the term "security" be interpreted broadly, and the Supreme Court has, on several occasions, observed that the definition of the term security "is quite broad . . . and includes both instruments whose names alone carry well-settled meaning, as well as instruments of 'more variable character' . . . ." <sup>45</sup> It is, thus, well settled that the term "security" is to be interpreted flexibly to encompass new instruments that are similar to, or have the characteristics of, instruments already recognized as securities. In particular, if "economic reality" suggests that such an instrument has the characteristics of instruments that clearly are securities, then it should be defined as a security, even if the instrument does not fit explicitly within the Act's enumeration of specific instruments that constitute securities. <sup>46</sup> Indeed, in a world of rapid development of new

<sup>45</sup> *Landreth*, 471 U.S. at 686 (1985) [quoting *Marine Bank*, 455 U.S. at 556 (1982); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943)].

<sup>46</sup> *Landreth* 471 U.S. at 694 (1985); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). Section 3(a)(10), 15 U.S.C. § 78(a)(10) (1982), defines the term "security" as including:

any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or

financial instruments, it cannot be expected that Congress would have identified the exact form of all instruments that constitute securities. <sup>47</sup>

IPs possess the key characteristics of stock. In *Landreth Timber Co. v. Landreth*, <sup>48</sup> the Supreme Court's most recent decision addressing the definition of the term "security," the Court described five characteristic features of stock as: (1) the right to receive dividends; (2) negotiability; (3) the ability to be pledged or hypothecated; (4) the capacity to appreciate in value; and (5) the conferring of voting rights in proportion to the number of shares owned. IPs have all of these characteristics, except voting rights, and have other characteristics of stock as well.

With regard to the *Landreth* characteristics: (1) IP purchasers will be entitled to receive on a quarterly basis cash payments equivalent to a proportionate share of any regular cash dividends paid on the component stocks of the underlying portfolio; (2) because IPs will be freely transferable in exchange transactions, such instruments will be negotiable in

right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

The Commission notes that the definitions of the term "security" in Section 3(a)(10) of the Act and Section 2(1) of the Securities Act of 1933 ("Securities Act") are virtually identical and have been treated as such by the Supreme Court in decisions dealing with the scope of the term. See, e.g., *Marine Bank*, 455 U.S. at 555 n.3 (1982); *United Housing Foundation, Inc. v. Foreman*, 421 U.S. 837, 847 n.12 (1975).

<sup>47</sup> While the Commission, in its analysis of IPs, has focused primarily on the portions of the definition discussed in the text, there may be additional bases for concluding that IPS are securities. For example, an IP can be analogized to a receipt for the interests in the securities upon which it is based or to a certificate of deposit for a security. In addition, an analysis of IPs as investment contracts also supports the conclusion that they are securities.

<sup>48</sup> 471 U.S. 681 (1985).

<sup>49</sup> *Id.* at 686-87.



the same sense as exchange-traded stock; (3) IP purchasers also will have the ability to pledge or hypothecate their IP interests;<sup>50</sup> and (4) IPs will have the capacity to appreciate in value as the underlying components appreciate in value.<sup>51</sup> The only characteristic cited in *Landreth* that IPs do not provide are voting rights in the stocks comprising the index. This difference is not, by itself, determinative inasmuch as there are many types of securities, including some types of stock, that do not possess voting rights. For example, preferred stock generally possesses either limited or no voting power.<sup>52</sup> Accordingly, the absence of voting rights does not preclude the characterization of IPs as a security.

IPs have two other important characteristics normally associated with stock. First, IPs do not expire. An investor can hold them for an indeterminate time, just as an investor may retain a portfolio of stock indefinitely. Second, purchase requirements and margin treatment for IPs are analogous to stock purchase and margin requirements. As with stock, an IP purchaser pays the full purchase price for his investment at the time of purchase. The IP purchase may be financed by borrowing up to 50% of the IP purchase price just as a stock purchaser may borrow up to 50% of the stock purchase price. Thus, a margin transaction in IPs includes an actual borrowing with the full purchase price then passed through to the IP seller. Accordingly, since IPs so closely resemble a portfolio

<sup>50</sup> A customer's agreement with his brokerage firm typically provides that an investor normally will pledge his interest in a security, including profits and dividends, as collateral to the broker for any indebtedness arising in connection with his account or any other indebtedness to the broker. In contrast, futures are executory contracts which may not be pledged, except regarding rights to contingent cash payments required by the futures contract.

<sup>51</sup> In addition, insofar as the Amex EIP is concerned, the purchaser or holder of the EIP has the right to receive physical delivery of shares of the component stocks of the Index if he exercises the delivery privilege regarding a sufficient number of EIPs.

<sup>52</sup> As the Court noted in *Landreth*, "various types of preferred stocks may have different characteristics and still be covered by the Acts." *Landreth*, 471 U.S. at 687, n.2 (1985).

of stock they should be included within the definition of stock in Section 3(a)(10).

IPs also fall within the term "certificate of interest or participation in" stock. IPs allow investors to replicate a purchase of a portfolio of securities because the value and benefits of IP ownership track the value and benefits of the stocks underlying the portfolio. In addition, IPs are expressly termed "participations."<sup>53</sup>

Although IP transactions will be reflected by book entries rather than by the transfer of paper certificates, the absence of such certificates does not remove them from the term "certificate."<sup>54</sup> The system for IP transfer is similar to the immobilized depository system used in connection with modern day securities transfers, which likewise do not require a formal certificate.<sup>55</sup>

<sup>53</sup> While the name of an instrument is not by itself dispositive in determining whether the instrument is included within the statutory definition of the term "security," the name is one factor taken into consideration. *Landreth*, 471 U.S. at 686 (1985); *United Housing Foundation v. Foreman*, 421 U.S. 837, 850 (1975).

<sup>54</sup> L. Loss & J. Seligman, II *Securities Regulation* 597, 997-98 n.286 (3d ed. 1989).

<sup>55</sup> The absence of a certificated instrument does not alter the characterization of an instrument as a security. In this regard, it is noteworthy that, under relevant state commercial laws, the definition of the term "investment security" does not turn on whether investors can obtain certificated instruments to evidence their ownership interests. *See, e.g.*, Del. Code Ann. tit. 6 § 8-102(1)(c) (1988) [Uniform Commercial Code § 8-102(1)(c)]. Under state commercial laws in effect in at least 35 jurisdictions, the term "investment securities" specifically includes "uncertificated securities," transfers of which are registered upon books maintained for that purpose by or on behalf of the issuer. *See, e.g.*, Del. Code Ann. tit. 6 § 8-102(1)(b) (1988); Ill. Ann. Stat. tit. 26 § 8-102(1)(b) (1988); Consolidated Laws of N.Y. Ann. Book 62 ½ § 8-102 (1)(b) (1989). OCC will issue all CIPs, EIPs, and VIPs, and will maintain books for registering transfers of the same.

In addition, other investments routinely are issued or held in book-entry form. Several types of securities commonly trade without any physical, negotiable certificates evidencing ownership interests. For example, U.S. Treasury Bills, Bonds, and Notes are issued exclusively in book-entry form



In addition to the fact that IPs fit within several of the more specific terms enumerated in Section 3(a)(10), it also is clear that the "economic substance" of an IP<sup>56</sup> is essentially indistinguishable from the economic substance of the more specific instruments that are defined as securities by the statute. An investor who owns an IP will own an instrument having the same economic substance as a portfolio of stocks. The financial returns on the IP will be substantially identical to the returns from holding the underlying portfolio: capital gains or losses will be directly related to the gains or losses from the portfolio's stocks; cash payments made quarterly to the IP holder will consist of an amount equivalent to the regular cash dividends paid by the issuers whose securities comprise the portfolio; and margining treatment for the IP purchasers and sellers is identical to stock margin requirements. Thus, because the "economic substance" of the purchase of an IP is equivalent to the purchase of a portfolio of stock, and the attributes of IPs are those commonly associated with securities, an IP constitutes "an instrument commonly known as a security."

To the extent certain IP characteristics differ somewhat from the characteristics of stock, they resemble characteristics commonly found in rights to purchase or puts or calls on a security or index of securities — interests specifically denominated as securities by the Act.<sup>57</sup> In this regard, the cash-out

through Federal Reserve Banks. Moreover, numerous states have issued debt securities that restrict significantly an investor's ability to obtain negotiable certificates. See Securities and Exchange Commission, 53rd Annual Report 35 (1987); 51st Annual Report 25, 120 (1985); Securities Exchange Act Release No. 22168 (June 25, 1985), 50 FR 27078.

<sup>56</sup> The Court has on several occasions held that "in searching for the meaning and the scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality." See, e.g., *Tcherepnin*, 389 U.S. at 336 (1967).

<sup>57</sup> The futures commentators suggest that IPs are dissimilar to index options because there is no apparent premium paid by an IP long. In this regard, while IPs contain some characteristics of stock index options (e.g., the issuance and clearance and settlement features of IPs are analogous to those of stock index options), the Commission believes that IPs predomi-

and physical delivery features of IPs are the equivalent of a put or call right that accompanies the portfolio of stock represented by the IP, much like "buy-sell" agreements for stocks.<sup>58</sup> In particular, the periodic cash-out feature merely creates a right similar to that commonly found in stock transactions where, at specified times, one party to a transaction has a right to purchase or sell a security according to a formula price that might be determined on the basis of book value, an appraisal, or a formula related to market value (whereas the IP right is related to the price of a specified index of securities).<sup>59</sup>

These additional attributes, like the other features of IPs, cause the IP to fall within the instruments included within the definition of the term "security" in Section 3(a)(10) of the Act.<sup>60</sup> Accordingly, for all of the above reasons, an IP is a security as defined in the Act.

## 2. IPs are not Futures

Futures commentators argue that the Commission lacks jurisdiction to authorize the trading of IPs on securities exchanges because IPs constitute stock index futures subject to the exclusive jurisdiction of the CFTC.<sup>61</sup> The Commission disagrees with the futures commentators' suggestion that IPs constitute futures contracts. The term "futures contract" is not defined in the CEA or the CFTC's regulations. While characterization of the term "future" requires an examination of all the surrounding circumstances, futures contracts generally are: (1) standardized contracts imposing a bilateral

nantly have the attributes of a portfolio of common stock.

<sup>58</sup> See, e.g., D. Gladstone, *Venture Capital Handbook* 129-30, 237 (1983); Arley Merchandise Corp., [1984-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,878.

<sup>59</sup> Moreover, the addition of a periodic "buy-sell" or "put-call" right does not transform a security subject to such a right into a future; nor does it transform a portfolio of stock subject to such a right into a future; and it does not transform an IP into a future.

<sup>60</sup> See 15 U.S.C. §§ 77b(1) and 78c(a)(10) (1982).

<sup>61</sup> See Section 2(a)(1)(B) of the CEA.

obligation for the purchase or sale of commodities at a specific price that provide for future, as opposed to immediate, delivery on a specific date; (2) directly or indirectly offered to the general public; (3) secured by earnest money or "margin;" (4) entered into primarily for the purpose of assuming or shifting risk as opposed to transferring ownership of commodities; and (5) generally extinguished by executing off-setting contracts prior to the date on which delivery is called for by acceptance of a cash payment representing the difference in price between the initial and off-setting transactions.<sup>62</sup>

Not all of these characteristics are equally significant in determining whether an instrument is a future. In particular, the phrase that most commonly appears in the CEA is "contracts of sale of a commodity for *future* delivery."<sup>63</sup> The CEA's emphasis on the futurity of the contracts subject to its regulation, the common meaning inherent in the term "futures" contract, and the fact that case law that has sought to define the term "futures contract" has relied extensively on the presence of future pricing (or delivery),<sup>64</sup> all suggest strongly that if a contract lacks the element of futurity it lacks the central distinguishing characteristic of a futures contract.

Since futurity is essential to a futures contract, and no element of futurity exists in an IP contract, an IP is not a futures contract. A stock index futures contract contains an

<sup>62</sup> Gilberg, Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws, 39 *Vand. L. Rev.* 1599, 1606-08 (1986). See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982); *CFTC v. Co Petro Marketing Group, Inc.*, 680 F.2d 573 (9th Cir. 1982); *CFTC v. National Coal Exch., Inc.*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,424 (W.D. Tenn. 1982); *In re First Nat'l. Monetary Corp.* [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,707 (CFTC 1983); *In re Stovall* [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 (CFTC 1979); Advance Notice of Proposed Rulemaking (Regulation of Hybrid and Related Instruments), 52 FR 47022 (December 11, 1987) at 47023.

<sup>63</sup> (emphasis supplied). I P.M. Johnson and T. L. Hazen, *Commodities Regulation* §1.03 at 9 (3d ed. 1989).

<sup>64</sup> See note 62, *supra*.

element of futurity because the contract is the obligation to pay for or receive the value of the index at a predetermined date in the future. In stark contrast, however, an IP contract represents the *present* obligation to pay or right to receive the *current* value of an underlying portfolio of securities. In this respect, an IP is substantially the same as a transfer of a portfolio of securities that also gives rise to the *present* obligation to pay or right to receive the *current* value of the underlying portfolio of securities. Whereas the price of the IP is determined at the date of purchase, a futures contract is contractually defined by reference to a price that must be paid or received on a specific date in the future.<sup>65</sup>

In addition to lacking the element of futurity, IPs do not share with futures the element of *bilateral* obligation to receive or to pay the value of the index at a specified date in the future. Once the purchaser of the IP has made full payment for the contract the purchaser has no continuing obligations,<sup>66</sup> only rights. The purchaser has the right to sell out the contract at any time, the right to hypothecate the contract, and the right to "cash out" the contract at pre-set periodic dates.<sup>67</sup> The obligation of an IP contract to make regular cash dividend equivalent payments falls unilaterally on the seller. The other obligation of an IP contract—to pay the present market price of the IP when the other side cashes

<sup>65</sup> The periodic cash-out feature of an IP does not cause the value of the IP ever to be defined on the basis of any price other than a *current* price, whereas the value of a future is always defined with reference to the expectation of the future price at the delivery date.

<sup>66</sup> If the IP purchaser has bought on margin, the purchaser may have a continuing margin obligation, but that obligation is to the lender, not to the IP seller. See note 40, *supra*.

<sup>67</sup> The Commission believes that the cash settlement feature of an IP does not support the futures commentators' argument that in substance an IP is a stock index future. In the 1982 amendments to the definition of the term "security" contained in both the Securities Act and the Act, Congress explicitly recognized that products designed to have the economic substance of securities are themselves securities, even though settled in cash on the basis of the value of an underlying index.



out—is also unilateral.<sup>68</sup> More importantly, the IP cash-out obligation is fundamentally different from the obligation inherent in a futures contract because the IP obligation is contingent upon exercise of the cash-out privilege. Indeed, unless the privilege is exercised, the obligation is perpetual until the holder of the obligation extinguishes its IP position. No futures contract has this characteristic.

As noted previously, in addition to the primary elements of futurity and bilateral obligation, several other characteristics have been used to determine the existence of futures contracts.<sup>69</sup> In particular, the characteristics of standardization and offset provide little meaningful assistance in determining whether an instrument is a futures contract rather than a security. Other markets, such as stock options markets, regularly offer standardized contracts to the general public without having those contracts considered “futures contracts.”<sup>70</sup> The fact that IPs are standardized and offered to the public neither adds to nor detracts from the Commission’s conclusion that IPs are not futures. Similarly, the offset characteristics of IPs and stock options are identical. Specifically, as in the case of options, the sale of an IP with the same terms as the one purchased, or the purchase of an IP with the same terms as the one sold, will extinguish the previously established IP position. The availability of a secondary market to offset an IP position thus fails to distinguish IPs from other securities that are not futures and provides no support for the categorization of IPs as futures.

The requirement that futures contracts generally be secured by earnest money margin further differentiates IPs from futures contracts. Margining practices for IPs and futures are

<sup>68</sup> The unilateral obligation falls only on the seller of a CIP or EIP, and on both parties with a VIP. The VIP obligations for the seller and purchaser are not bilateral in that each is discretionary because it is dependent on the exercise of the right imposing that obligation.

<sup>69</sup> *Supra* note 62 and accompanying text.

<sup>70</sup> As another example, insurance contracts also are standardized, offered to the public, and can rely on the occurrence of future events, but are not considered “futures contracts.”

dramatically different. As noted above, as with stock, an IP purchaser pays the full purchase price for the IP investment at the time of purchase. Margin treatment for IPs will be analogous to stock margin requirements. The investor is required to pay the full purchase price of the IP at the time of purchase, but may borrow up to 50% to pay for the purchase. Thus, IP margins regulate credit. This is entirely unlike a futures transaction in which margin acts as a “good faith” deposit to ensure that the parties will meet their contractual obligations in the future.<sup>71</sup> Accordingly, the “margin” element of the definition of futures suggests that IPs are securities, not futures contracts.

The CME argues that, while an IP long position is entitled to be held indefinitely, the quarterly cash-out feature creates a quarterly expiration identical to the cycle now applicable for similar futures contracts. The CME asserts that this feature is synonymous with an “undated futures market

<sup>71</sup> See generally Figlewski, *Margins and Market Integrity: Margin Setting for Stock Index Futures and Options*, 4 *J. Futures Markets* 385 (1984). As recently explained in a Congressional report:

Futures margins do not regulate credit, since no credit is granted on futures contracts. Futures margins constitute a (partial) guarantee that both parties will honor their financial obligations and thus function as a kind of performance bond. Moreover, futures margins, unlike securities margins, must be posted daily (sometimes intra-daily) to cover all daily losses on futures contracts. Report on the Regulation of Futures Margins, Comm. Print 100-6 (Aug. 1988) at 1, 8.

The futures commentators have argued that securities-style margining is fundamentally different from futures-style margining, and, for the reasons set forth by those commentators, the Commission agrees that IPs margins do not have the “earnest money” characteristic of futures contracts. See, e.g., Testimony of William F. Brodsky, President, CME Before the House Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs (May 25, 1988) at 2-4; Statement of Karsten Mahlmann, Chairman, CBT Before the House Domestic Monetary Policy Subcommittee of the Committee on Banking, Finance and Urban Affairs (May 25, 1988) at 34; Notice of Petition for Rulemaking (Domestic Exchange-Traded Commodity Options; Margins), 54 FR 11233 (March 17, 1989).



contract.”<sup>72</sup> The CME asserts further that the outcome of effective competition will be that at the time of purchase an IP long actually will pay a higher IP price reflecting payment of a commission to “roll over” the position, at the quarterly expiration date. The analogy to undated futures markets fails, however, for independent economic and legal reasons, and the contention that IP pricing will reflect payment of a “commission” to “roll over” this position is both speculative and irrelevant.

First, undated “futures” markets<sup>73</sup> require the joint determination of two prices: a spot commodities price and an associated intra-day interest charge<sup>74</sup> that is normally equal to the interest that could be earned by investing an amount equal to the value of the commodity plus the cost of one day’s storage, *i.e.*, one day’s carrying cost.<sup>75</sup> An investor cannot participate in the undated futures market without also paying or receiving the associated interest charge. Because of the need to incur this associated interest charge, the “futures contract” never gives rise to a present interest in the current value of a commodity. In contrast, IP contracts have no associated interest charge and constitute a *present* interest in a *current* value of an underlying portfolio. Thus, the presence of the associated interest charge creates in an “undated” futures market an element of futurity wholly absent from IPs.

<sup>72</sup> See, e.g., 1st CME Letter at 2 [citing Gehr, Undated Futures Markets, 8 *J. Futures Markets*, 89 (1988)].

<sup>73</sup> Gehr describes the market studied in his article as a “curiosum.” Gehr, *supra* note 72, at 89. No such curiosa exist in U.S. financial markets. Moreover, the fact that these markets might be called “futures” in Hong Kong or elsewhere does not mean that they would be defined as futures under the CEA. Finally, even if such markets were defined as futures markets under the CEA, the presence of a daily interest charge still would distinguish them from IPs.

<sup>74</sup> The daily “interest” payments, made for the privilege of deferring, making or taking delivery of the commodity, may be “positive,” paid by sellers to buyers, or “negative,” paid by buyers to sellers. Gehr, *id.*, at 90-91.

<sup>75</sup> See Gehr, *id.*, at 91.

Second, in regard to the suggestion that an IP long will pay a commission, in the form of higher prices, to “roll over” the position, the Commission believes that IP prices will be based largely on the value of the underlying portfolio and anticipated dividends on the components of the underlying index. The Commission does not believe that a “roll over” expense necessarily will be incorporated into an IP premium. Moreover, even if such a *de facto* charge were to develop, the Commission does not believe that such a charge would transmute the IP into a “contract for future delivery” of the underlying index because of the IPs’ other distinguishing characteristics.

The CME also suggests that the IP dividend payment is analogous to a cash payment from the short to the long, related to measured or theoretical shrinkages in the value of the underlying product, as occurs in the frozen skinned ham futures market.<sup>76</sup> The Commission observes, however, that dividends are discretionary corporate payments, the size of which is determined on a voluntary basis by the corporation’s board of directors. Corporations can raise or lower dividends, and the right to receive dividends is a significant attribute of stock. Thus, the payment of a cash dividend equivalent to IP holders ensures that the IP contains the investment features of stock. In contrast, the shrinkage factor in a frozen skinned ham futures contract is determined according to a pre-set formula calculated in order to assure that purchasers of frozen skinned hams do not pay for a weight that will not exist at that point in the future when the contract expires and the ham has shrunk. The shrinkage factor is thus inexorably linked to the futurity of the ham contract (*i.e.*, but for futurity, no price adjustment for shrinkage would be necessary). The IP contract has no futurity, is not subject to shrinkage, and receives and pays dividends based on discretionary corporate decisions. The Commission thus rejects the argument

<sup>76</sup> See 1st CME Letter at 2-3.

that IPs should be considered futures because the shrinkage of frozen skinned hams is similar to the payment of corporate dividends.

Finally, the CME suggests that the Phlx daily CIP cash-out does not alter its characterization as a futures contract. In this regard, the CME claims that:

the differences between the S&P Futures and CIP are insignificant, relating solely to a probable slight difference in pricing related to the theoretical daily convergence of the cash and futures contract in the case of the PHLX CIP and the quarterly convergence in the case of the CME's S&P 500 futures. That difference is defined by well established arbitrage relationships reflecting the differences in maturity dates.<sup>77</sup>

It is not at all clear that the pricing differences between the S&P 500 future and the CIP will be "insignificant." Pricing of IPs and index futures should diverge because of the substantial differences in margining practices, divergences between an IP's perpetual nature and the quarterly expiration feature of a stock index future, and the payment of regular cash dividend equivalents on IPs. In addition, IPs will trade on markets with different marketmaking characteristics and may be bought or sold by retail investors who may not participate in the futures markets.<sup>78</sup> Many IP investors also may be effectively prohibited from participating in futures markets as a result of regulatory constraints or contractual prohibitions. Therefore, because of differences in the structure of the instruments, trading practices, and investor populations, it is unsubstantiated speculation to contend that the difference in pricing between IPs and index futures will be "insignificant."

In addition, the pricing differences between the S&P 500 future and all IPs (including those with quarterly cash-outs) will not replicate the formula commonly used to determine

<sup>77</sup> See 5th CME Letter at 1.

<sup>78</sup> See note 96, *infra* and accompanying text.

the theoretical value of a stock index futures contract. Such a formula would add the interest on the price of the portfolio to the index price, subtract the annualized dividend yield, and factor in the days remaining until expiration.<sup>79</sup>

The futures commentators suggest that by manipulating the terms of this and similar equations they are able to demonstrate algebraic relationships between the pricing of IPs and the pricing of futures contracts, and thus that IPs should be regulated as futures because they are priced "like" futures. These equations, however, also can be used to demonstrate, by a different manipulation of the equation's terms, that existing futures contracts are equivalent to a straightforward stock portfolio position. It simply does not follow that futures should be regulated as stocks because they are priced "like" stocks, or vice versa. Similarly, IPs should not be regulated as futures merely because an algebraic manipulation of a pricing formula might demonstrate that they are priced like futures. Thus, the CME emphasis on pricing similarities is not determinative.

Other somewhat more complex arbitrage and equivalence relationships also do not serve to demonstrate that IPs are futures. For example, it is possible to create a synthetic future on a stock index by purchasing European style calls and writing European style puts that have appropriate exercise prices and times to maturity.<sup>80</sup> "Hence when options on

<sup>79</sup> See generally B. Byrne Jr., *The Stock Index Futures Market* 170 (1987). The pricing formula contains the following elements:

Futures price = (Stock Portfolio Price) + [(Risk Free Interest Rate - Annualized Dividend Yield on Stock Index) x Days Until Expiration / 365].

Unlike futures, the interest on the difference between full payment for a portfolio of stocks and the earnest money margin payment for a future would not be relevant to IP pricing because IPs are fully paid for at the time of the purchase. In addition, the value of expected dividends on the portfolio would not be subtracted because the IP purchaser would have the right to receive the equivalent of those regular cash dividends.

<sup>80</sup> T. Copeland & J. Weston, *Financial Theory and Corporate Policy* 322 (3d ed., 1988).



an asset or commodity are traded, but there is no futures market, it is always possible to construct a synthetic futures contract."<sup>81</sup> It does not follow, however, that, because futures positions can be replicated by options positions, futures are really options. Likewise, it does not follow that, because options positions can be replicated by futures, options are really futures. Similarly, futures can be used to replicate a variety of other securities. For example, futures can be used to create a portfolio that has the cash flow characteristics of a broad based equity portfolio. Again, it does not follow that an equity portfolio should be regulated as a future or that an index future should be regulated as a security because it is possible to define an arbitrage or equivalence relationship between them. Thus, while the modern theory of finance and its virtually limitless repertoire of equivalence relations may be very valuable for arbitrage, pricing and other analytic purposes, it is of little value when it comes to addressing the technical, legal issues of jurisdiction posed by the introduction of IPs and other financial products. Indeed, the limitless use of such models would be plainly inconsistent with the structure of the CEA and the securities laws, which are designed to separate regulation of futures and securities.<sup>82</sup>

<sup>81</sup> *Id.* at 323.

<sup>82</sup> When Congress in the CEA expanded the definition of the term "commodity" to include "all services, rights and interests in which contracts for future delivery are presently or in the future dealt in," it carefully preserved this Commission's jurisdiction, including its authority to regulate novel instruments as securities. Specifically, Congress included a proviso that, with the exception of the grant of exclusive jurisdiction regarding contracts for future delivery, "nothing contained in this section shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission . . . or (ii) restrict the Securities and Exchange Commission . . . from carrying out [its] duties and responsibilities . . . ." This is further emphasized in Section 2(a)(1)(A) of the CEA which provides that "nothing in this Act shall be deemed to govern or in any way be applicable to transactions in . . . security rights . . . unless such transactions involve the sale thereof for future delivery conducted on a board of trade." 7 U.S.C. § 2(a)(1)(A) (1982) (emphasis supplied).

The intent of Congress not to limit this Commission's traditional jurisdic-

Moreover, the determination that IPs are securities and not futures contracts is in no way inconsistent with the purposes of the CEA and subsequent amendments thereto. Futures regulation at the federal level is a direct outgrowth of serious problems in the marketplace that Congress perceived as detrimental to interstate commerce and the national public interest.<sup>83</sup> In 1936, when the CEA was enacted (extensively amending the Grain Futures Act of 1922), Congress recognized that pervasive manipulation, excessive speculation, trading abuses (*e.g.*, wash sales, fictitious trades, and accommodation trades), and the rampant growth of boiler-rooms threatened to destroy the utility of the futures markets. In 1974, Congress determined that additional tools were necessary to ensure adequate regulation of all futures trading and futures professionals and to allow for the extension of the economic benefits of futures trading to those areas of commerce where the functions of futures markets might be useful.

Approval of IPs for trading on securities exchanges, in a fully regulated environment, would not give rise to the abuses that Congress sought to prevent by adopting the CEA. As exchange-listed securities, IPs will be subject to a comprehensive regulatory structure under the federal securities laws and to Commission oversight similar to the regulatory regime

tion over the wide variety of financial instruments which fall within the broad definition of the term "security" under the federal securities laws was expressed repeatedly in the Act's legislative history. For example:

Although the expanded definition of 'commodity' . . . includes rights and interests which are securities as defined in the federal securities laws . . . except as to transactions [involving delivery on a contract market], the expanded definition of commodity is *not intended to derogate [sic] from the jurisdiction of the Securities and Exchange Commission . . .*

See Report of the House Comm. on Agriculture to Accompany H.R. 13113, H.R. Rep. No. 93-975, 93d Cong., 2d Sess. 28 (1974) (emphasis supplied).

Attempts to rely on arbitrage relationships to limit the scope of the Commission's jurisdiction over contracts that are not for future delivery are thus directly at odds with the language and intent of the CEA.

<sup>83</sup> 7 U.S.C. § 5 (1982).



applicable to futures under the CEA.<sup>84</sup> Indeed, the CFTC's regulatory authority over contract markets was modeled in part on the Commission's authority over securities exchanges.<sup>85</sup>

### 3. *IPs Are Not Subject to the Investment Company Act*

The Commission believes that an IP does not involve the creation of an investment company, because there is no "issuer," within the meaning of Section 3(a) of the Investment Company Act of 1940, 15 U.S.C. § 80a-3, that is either "engaged . . . primarily in the business of investing, reinvesting, or trading in securities" or "engaged . . . in the business of investing, reinvesting, owning, holding, or trading in securities, and owns . . . investment securities having a value exceeding 40 per centum of the value of such issuer's total assets . . . ." Moreover, OCC, the issuer of IPs, is a clearing agency registered as such under the Act. A clearing agency cannot be registered as such under the Act until the Commission makes certain findings required by Section 17A(b)(3), including that the clearing agency has the capacity to facilitate the prompt and accurate clearance and settlement of se-

<sup>84</sup> Bromberg, *Commodities Law and Securities—Overlaps and Pre-emptions*, 1 J. Corp. L. 217, 269 (1976). For example, both the Commission and the CFTC have the power to: (1) determine which contract markets and securities exchanges may operate under their respective jurisdictions; (2) establish the rules of membership and operation for the markets and exchanges under their respective jurisdiction; (3) oversee the exercise of self-regulatory authority by such markets and exchanges; (4) approve specific instruments for trading on those markets and exchanges; and (5) establish rules governing the registration and activities of brokers on those markets and exchanges. Indeed, it is important to note that both the securities and futures acts place a substantial emphasis on competition. Compare 15 U.S.C. §§ 78f, 78o, and 78o-3 (1982) with 7 U.S.C. § 19 (1982). In this regard, there is no basis upon which to conclude that Congress sought to adopt an expansive definition of the term "futures contracts" for the purpose of preventing competition by organized securities markets with the commodity markets.

<sup>85</sup> Courts also have observed that the "[s]tructure and power of the CFTC are duplicative of the SEC." *Mullis v. Merrill Lynch, Pierce, Fenner, & Smith, Inc.*, 492 F. Supp. 1345, 1350 (D. Nev. 1980).

curities transactions and to safeguard securities and funds in its custody. These qualifications support the conclusion that the OCC would be an issuer primarily engaged "in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities."<sup>86</sup> Moreover, given the existing securities law regulation of the OCC under Section 17A of the Act and the exchanges under Section 6 of the Act, the Commission sees no purpose that would be served by subjecting this arrangement to investment company regulation.

Nor does there exist an investment company within the OCC (or OCC combined with the exchanges), the IP purchasers viewed collectively, or the IP shorts viewed collectively. Unlike *Prudential Ins. Co. v. SEC*,<sup>87</sup> where the Third Circuit affirmed a finding of the Commission that the "Investment Fund" resulting from the sale of annuity contracts to a group of purchasers<sup>88</sup> constituted a separate investment company, the Commission has found no separate investment company herein. In the case of IPs, nothing exists comparable to the Investment Fund in *Prudential*, which the court found to be a "completely segregated account, devoted to investing in securities."<sup>89</sup>

### B. *Benefits of Market Baskets*

The Division of Market Regulation's Report on *The October 1987 Market Break* ("Staff Report"),<sup>90</sup> *An Overview of*

<sup>86</sup> See Section 3(b)(1) of the Investment Company Act of 1940. 15 U.S.C. § 80a-3(b)(1) (1982).

<sup>87</sup> 326 F.2d 383 (3d Cir. 1964), *cert. denied*, 377 U.S. 953 (1964).

<sup>88</sup> As discussed earlier, the term "investment company" requires a finding that there exists an "issuer;" the term "issuer" is, in turn, defined to include "every person;" the term "person" is defined to include a "company;" and "company" is defined to include "any organized group of persons, whether incorporated or not." 15 U.S.C. §§ 80a-3(a)(1), 2(a)(22), 2(a)(28), 2(a)(8) (1982).

<sup>89</sup> *Prudential*, 326 F.2d at 387 (1964).

<sup>90</sup> Division of Market Regulation, *The October 1987 Market Break* (February 1988) ("Staff Report").

*Program Trading and Its Impact on Current Market Practices* ("Katzenbach Report"),<sup>91</sup> Commission recommendations,<sup>92</sup> and testimony by the Commission<sup>93</sup> suggested, among other things, that the listing and trading of a basket of stocks on an exchange could help ameliorate the volatility and steep stock price declines experienced during and since October 1987. As noted in the Staff Report, the creation of one or more posts where actual baskets or portfolios of stock could be traded could alter the dynamics of program trading, because the availability of such basket trading could, in effect, restore program trades to more traditional block trading techniques.<sup>94</sup> The Staff Report noted further that, while arbitrage ultimately would flow to individual component stocks, many institutional investors and member firms effecting index arbitrage transactions could focus their equity transactions at the basket posts where the specialist and trading crowd could provide efficiencies associated with effecting transactions in a portfolio of securities as opposed to individual stocks. This could add an additional layer of liquidity to the market to help absorb the velocity and concentration of trading associated with index-related trading strategies.<sup>95</sup> Moreover, because market baskets would be traded at a single location on the exchange floor, at which program trading order flow could be concentrated and imbalances in such

<sup>91</sup> N. Katzenbach, *An Overview of Program Trading and Its Impact on Current Market Practices* (December 21, 1987) ("Katzenbach Report").

<sup>92</sup> Securities and Exchange Commission Recommendations Regarding the October 1987 Market Break (February 3, 1988).

<sup>93</sup> Testimony of David S. Ruder, Chairman, SEC, Before the Senate Committee on Banking, Housing, and Urban Affairs, on February 3, 1988.

<sup>94</sup> Staff Report at 3-18.

<sup>95</sup> *Id.* Similar ideas have been discussed in J. Grundfest, "Would More Regulation Prevent Another Black Monday?," Address before the CATO Institute Policy Forum on July 20, 1988, at 13-14 (available at the Commission); H. Stoll and R. Whaley, *Program Trading and the Monday Massacre* (November 4, 1987) (available at the Owen Graduate School of Management, Vanderbilt University); and H. Stoll, *Portfolio Trading*, Working Paper No. 87-14 (Sept. 1987) (available at the Owen Graduate School of Management, Vanderbilt University).

trading determined, they would not result in the same market information limitations that result from executing program trades in the individual stocks. Finally, as separate consolidated products, market baskets would be easy and inexpensive to clear and settle and could provide an alternative vehicle for retail customers to invest in "the market."

For the reasons discussed below, the Commission believes that IPs will provide retail investors with a cost efficient means to make investment decisions based on the direction of the market as a whole<sup>96</sup> and may provide stock market participants several advantages over existing methods of effecting program trades of stocks.<sup>97</sup>

Because IPs would be traded as market baskets at a single specialist post on the exchanges' floors, program trading order flow involving IPs can be concentrated at that post and imbalances in such trading determined. Thus, IPs trading would not result in the same market information limitations that result from executing program trades in individual stocks. Moreover, the availability of IPs may provide a more efficient alternative to direct program trades of individual

<sup>96</sup> Because of the small retail size of index participations and the attendant costs of executing sufficient IP transactions in an attempt to replicate large portfolios, the Commission believes that such instruments are designed to handle retail investor interest to invest in the "market". The Phlx, Amex, and CBOE believe that IPs could be used by retail investors to make investment decisions based on the direction of the market as a whole, thereby providing them with a cost efficient means by which to take advantage of anticipated market swings. In addition, an IP investment could provide an individual investor with an additional source of securities income. The product could also be useful to institutional investors for their investment strategies.

<sup>97</sup> In this regard, the Commission believes that the listing and trading of IPs on national securities exchanges may reduce market volatility associated with program trades of stock because, excluding the Amex EIP, IPs generally will be cash-settled, and existing exchanges' stock index options surveillance procedures will be applicable to IPs. The Amex notes that the share delivery alternative provides a feature discussed in the Staff Report and will enhance the utility of EIPs for institutions. Staff Report at 3-19 to 3-20.



stocks for some institutional investors. Finally, as a separate product, IPs would be easy and inexpensive to trade, clear and settle.

### *C. EIP Physical Delivery Proposal*

The Commission also believes that the Amex proposal to permit physical delivery of its EIPs is consistent with the Act. Indeed, the availability of physical delivery permits institutions to employ EIPs to adjust their stock portfolios. As a result, EIPs may have greater potential for providing the liquidity benefits envisioned for market baskets in the Staff Report. Although providing certain benefits, the Amex's proposed EIP physical delivery does raise some concerns. The Amex's proposed rule change provides for a physical delivery facilitator ("PDF") to make physical delivery of the component stocks of the underlying portfolio to EIP holders who exercise the delivery privilege, if and only if, the number of delivery units for which holders have requested physical delivery exceeds the number of delivery units offered for physical delivery by persons holding short positions. The Amex proposes to inform the PDF, several hours before the opening of trading, of the imbalance between delivery units offered and delivery units demanded in order that the PDF may make arrangements that would enable it to obtain as agent at the opening the additional shares of the stocks that constitute the underlying portfolio to satisfy its obligations.

The Commission believes that PDF pre-opening knowledge of the imbalance between delivery units offered and delivery units demanded can provide the PDF with an informational advantage concerning pre-opening order flow. Because this imbalance would always be on the buy side, and because its existence and magnitude would be known only to the PDF, the AMEX proposal raises the possibility that the PDF might take advantage of the information by establishing or liquidating stock, options, and/or futures positions. In this regard, however, the Amex will place restrictions on the PDF's function. In particular, the PDF must announce to the trading crowd, and the Exchange shall cause to be publicly

reported, the physical delivery unit imbalance at or prior to 9:00 A.M. on Exercise Friday. Thus, the PDF's opportunity to trade on "inside" market information should be substantially reduced. Moreover, because the PDF must satisfy the physical delivery unit imbalance only by purchasing such imbalance at the opening rather than utilizing its existing inventory, the PDF's role is limited to that of an agent. Accordingly, the Commission believes the Amex has sufficiently addressed any concerns about the physical delivery mechanism.

### *D. Phlx Blue Chip Index*

Certain of the proposed underlying portfolios, such as the Amex MMI and the S&P 500, have been published for several years and have been used as a basis for stock index options trading. In approving these portfolios as bases for options trading (and commenting on them for futures trading), the Commission has determined that the use of these underlying portfolios does not raise manipulation concerns.<sup>98</sup> The Commission believes that the introduction of IPs based on these portfolios should not raise additional manipulation concerns.<sup>99</sup> The Phlx, however, has developed, specifically for IPs trading, a new Blue Chip CIP.

<sup>98</sup> See Section 6(b)(5) of the Act, 15 U.S.C. § 78f(b)(5) (1982), which requires that the rules of a national securities exchange be designed to prevent fraudulent and manipulative practices.

<sup>99</sup> The Commission believes that IPs will not raise the same problems as other portfolio-related products regarding to intermarket trading strategies that at times may have increased the concentration and velocity of market movements. While the Commission notes that IPs will create arbitrage opportunities with either the cash market or other derivative products, and may spawn new intermarket trading strategies, because of the proposed 50% margin requirement for IPs (analogous to stock margin requirements) the leverage concerns that exist with other equity derivative products are absent. See Report of the Presidential Task Force on Market Mechanisms (January 1988), at III-7; Division of Market Regulation, *The October 1987 Market Break*, (February 2, 1988) at 11-1. Moreover, by providing market participants with a means to trade "the market" without buying and selling dozens or hundreds of individual stocks, IPs could lessen the impact of portfolio trading strategies.

For several reasons, the Commission does not believe that the Blue Chip CIP raises significant manipulation concerns. Although the Blue Chip CIP is comprised of only 25 securities, it represents approximately 13 industry groups and is designed specifically to replicate the performance of the DJIA. The broad diversification, large capitalization, and deep and liquid markets of the portfolio's component stocks significantly minimize the potential for manipulation.<sup>100</sup> The ten most highly price-weighted stocks in the Blue Chip CIP account for less than 58% of the portfolio's cumulative market value.<sup>101</sup> Although IBM accounts for 8.73% of the Blue Chip CIP's price-weighting, the Commission believes manipulation of the CIP through trading in IBM is made more difficult because the stock is widely held and actively traded.<sup>102</sup> In addition, the proposed trading of IPs by the exchanges, which already have well-established stock and options surveillance procedures, does not appear to give rise to major surveillance concerns because existing surveillance procedures will be applicable to IPs trading. In addition, the Phlx has the necessary surveillance sharing arrangement with the exchanges whose securities comprise the Blue Chip CIP. Specifically, the Phlx and the NYSE are members of the Intermarket Surveillance Group ("ISG").<sup>103</sup> As members, these markets are required to share surveillance information with one another.

<sup>100</sup> The Blue Chip CIP is price-weighted. Accordingly, an issue's weight in the total portfolio value is based on its price per share rather than its total market capitalization (i.e., price per share times the number of shares outstanding).

<sup>101</sup> By comparison the 10 most highly price-weighted stocks in the MMI account for approximately 70% of that portfolio's cumulative market value.

<sup>102</sup> For the period February 1988 through January 1989, IBM's Average Daily Volume ("ADV") was approximately 1,357,900 shares.

<sup>103</sup> The on-going task of the ISG is to create and maintain a coordinated intermarket surveillance system to ensure that intermarket surveillance concerns are appropriately addressed.

### *E. Proprietary Concerns*

In general, the Phlx argues that simultaneous Commission approval of Amex's proposed rule change to trade IPs would neither be in the public interest nor promote fair competition among exchange markets. In support of this view the Phlx suggests that Commission approval of Amex's "copy cat" filing would deprive the Phlx (which claims to be the IP developer) of the opportunity to take advantage of the primary market phenomenon. In addition, the Phlx suggests that such Commission approval would stifle product innovation, design, and creativity. The Commission is of the view that approval of the Amex and Phlx proposals simultaneously is consistent with the Act.

To the extent that Phlx's "copy cat" argument implicates a claim of misappropriation or infringement of a protected property right, the Commission believes it is inappropriate for it to attempt to resolve these issues in a proceeding involving the approval of securities to be traded in a particular market place. Congress has enacted an elaborate statutory framework for the establishment, preservation, and protection of intellectual property rights and established specific federal agencies (e.g., the U.S. Patent and Trademark Office and the U.S. Copyright Office), to administer these laws. Separate state causes of action also may be available to Phlx. Neither the plain language of these statutes nor any provision of the Act suggests that Congress intended that the Commission attempt, in the context of an approval proceeding, to resolve intellectual property right claims that can be pursued elsewhere.

Moreover, while the Commission recognizes that, under the appropriate circumstances, incentives for innovation can promote long term competition and provide substantial benefits to the marketplace, on the basis of the record in this proceeding the Commission believes that simultaneous approval of the Phlx, Amex, and CBOE proposals is consistent with the Act. The Commission has been presented with numerous proposals to list and trade new securities products in recent



years. In particular, the Commission, on November 22, 1982, approved a number of exchange proposals to trade narrow and/or broad based index options, often on similar or identical indexes, although such indexes were submitted to the Commission on different dates.<sup>104</sup>

The Commission recognizes Phlx's argument that IPs are a novel product involving substantially more innovation than past new options products. Nevertheless, the Commission believes that the opportunity for competition among markets trading IPs simultaneously furthers the purposes of the federal securities laws.<sup>105</sup> Past experience has indicated that an exchange which initially commences trading an options contract has an extremely large advantage over any subsequent competitor. Accordingly, the Commission is concerned that a temporary grant of exclusivity to the Phlx could have the effect of substantially reducing potential future competition in IPs, which effect outweighs the benefits of incentives to innovation that might, in this case, result from a temporary grant of exclusivity. Thus, the Commission has concluded that simultaneous approval of the proposals is consistent with the Act.

#### *F. Regulation of Member Organizations Doing Business with Public Customers*

##### *1. Disclosure*

In order to promote investor protection and to ensure adequate disclosure in connection with IPs, the Phlx, Amex,

<sup>104</sup> See Securities Exchange Act Release No. 19264 (November 22, 1982), 47 FR 53981.

<sup>105</sup> See Securities Exchange Act Release Nos. 18297 (December 2, 1981), 46 FR 60376 ("Unrestricted inter-exchange competition in the non-equity options markets most likely would result in the development of options contracts best suited to the economic needs of market participants rather than discourage innovation, research, and development of new products"), 22026 (May 8, 1985) 50 FR 20310 ("The goals of the Act are inconsistent with affirmatively delaying the start-up of trading in options on over-the-counter stocks in a manner that benefits one particular market place because there is no regulatory purpose which would require such a delay").

and CBOE propose that their rules pertaining to standardized options and the requirements of Commission Rule 9b-1 also apply to IPs trading.<sup>106</sup> In this regard, the OCC requests that the Commission issue an order pursuant to Rule 9b-1(a)(4) of the Act, treating IPs for disclosure purposes as another type of security that should be treated in a manner similar to "standardized options" under Rule 9b-1.<sup>107</sup> OCC suggests that each of the reasons cited by the Report of the Special Study of the Options Market ("Options Study")<sup>108</sup> for establishing a separate disclosure system for standardized options applies equally to IPs.

As with other securities issued by OCC, the clearing corporation interposes itself between IP buyers and sellers, and is technically the "issuer" of each contract. Moreover, just as with other OCC issued securities, the Commission believes providing investors with detailed descriptive information regarding the issuer would not be useful. Instead, a

<sup>106</sup> The applicability of Rule 9b-1 relieves an issuer from the requirement of delivering a prospectus to each IP customer. Nevertheless, an issuer must deliver its prospectus to each market upon which the IPs are traded, for the purpose of redelivery to IPs customers upon their request.

<sup>107</sup> See Letter from William H. Navin, Schiff Hardin & Waite, OCC legal counsel, to Richard G. Ketchum, Director, Division of Market Regulation, and Linda C. Quinn, Director, Division of Corporation Finance, SEC, dated July 6, 1988 ("Schiff Letter"). The Schiff letter requests also that IPs be treated in a manner similar to standardized options for purposes of Rules 134a and 153b and Form S-20 under the Securities Act of 1933 ("Securities Act"). In addition, the Schiff letter requests that the Commission staff confirm that IPs will be treated in a manner similar to standardized options for the purpose of calculating Securities Act registration fees and that Form 8-A will be available for IP registration under the Act notwithstanding that OCC is exempt from the periodic reporting requirements of the Act. See Schiff letter at 5 and 6 for a more detailed explanation. Moreover, although the exchanges have not requested exemption of IP underlying securities from the applicability of Rule 12a-6 of the Act, the Commission notes that pursuant to that Rule IP underlying securities are exempt from the operation of Section 12(a) of the Act.

<sup>108</sup> *Report of the Special Study of the Options Markets to the Securities and Exchange Commission*, 96th Cong., 1st Sess. (Comm. Print 1978) ("Options Study").

disclosure document that provides a discussion of the terms and risks of IPs would appear to be substantially more useful to investors.

The Commission believes that the reasons cited by the 1978 Options Study for establishing a separate disclosure system for other OCC issued securities are equally applicable to IPs. First, regular disclosure under the Securities Act of 1933 ("Securities Act") focuses on disclosures regarding the issuer of the security. As with other OCC issued securities providing this type of disclosure to investors is not useful for IPs. While OCC's solvency is obviously relevant, an investor primarily is purchasing the equivalent of a portfolio of stock. Accordingly, a disclosure document that provides a discussion of the terms and risks of IPs would appear substantially more useful to investors. Second, delivery of a Securities Act prospectus to all IP investors and redelivery of any updated prospectus would be an inefficient and unnecessarily costly way of educating the public regarding IPs. In this regard, OCC has prepared a special IPs disclosure document ("IDD") explaining in detail the economic and risk characteristics of IPs, the mechanism of buying, selling and exercising IPs, and the market in which IPs will trade.<sup>109</sup>

In addition, the Amex, Phlx, and CBOE propose to require that every exchange member and member organization deliver to each customer a current IDD at or prior to the time such customer's account is approved for IPs trading.<sup>110</sup>

<sup>109</sup> In reviewing any disclosure materials submitted, the Commission intends to assure that the materials specifically describe IPs, explain their uses, detail the special risks associated with IPs trading, and emphasize that IP contracts, unlike options, obligate a writer to pay to the holder an amount equivalent to a proportionate share of dividends declared on the underlying index components.

<sup>110</sup> See, e.g., Amex Rule 926(a). The Commission believes that prior distribution of the IDD to investors is necessary before that person may effect a transaction in IPs. This prior distribution could be accomplished by physically delivering an IDD to an investor before he effects an IP transaction or by a mass mailing of the IDD to customers who have been approved for options trading, followed by a period of time in which inves-

As a result, the Commission believes that IPs are a type of security that falls into the category of "other security" under Rule 9b-1 which the Commission should treat in a manner similar to standardized options for purposes of Rule 9b-1 under the Act.<sup>111</sup> Indeed, in amending the definition of the term standardized option to include "such other securities as the Commission may, by order, designate" the Commission noted that it added the new language "to authorize the Commission, by order, to allow the use of Rule 9b-1 for new investment vehicles that the Commission believes should be included within the new disclosure framework."<sup>112</sup>

For the reasons discussed above, the Commission also believes that IPs should be treated in a manner similar to standardized options for purposes of Rules 134a and 153b and Form S-20 under the Securities Act. The Commission further believes that IPs should be treated similarly to standardized options for purposes of calculating Securities Act registration fees and that Form 8-A will be available for IP registration under the Act.

## 2. Marketing of IPs

The exchanges propose further that their existing options suitability rules<sup>113</sup> be applied to IP transactions. In general, under these procedures, before approving a customer's account for stock options trading, a firm must seek to obtain background and financial information including, among other things, the customer's investment experience, employment status, net worth, annual income, age, and investment objectives.

The Commission believes it appropriate that the exchanges apply the heightened suitability requirements of their options suitability rules to IPs transactions. Thus, no tors could comprehend the IDD and other relevant information pertaining to the economic and risk characteristics of IPs trading.

<sup>111</sup> 17 C.F.R. § 240.9b-1(a)(4) (1988).

<sup>112</sup> See Securities Exchange Act Release No. 19055 (September 16, 1982), 47 FR 41950, 41954.

<sup>113</sup> See, e.g., Phlx Rule 1026; CBOE Rule 9.7.



exchange member or member organization shall recommend to any customer any IP transaction unless such member or member organization has reasonable grounds to believe that the recommended transaction is not unsuitable for such customer.

The exchanges also propose that registered representatives who are qualified to sell stock index options should not be required to take a separate examination in order to transact business concerning index participations.<sup>114</sup> In addition, the exchanges do not propose that Registered Options Principals be required to take a separate IPs examination to qualify to act in a supervisory capacity with respect to the sale of IPs to public customers. The Commission concurs with the exchanges' proposals.<sup>115</sup>

In addition, the exchanges propose that IPs be subject to position and exercise limits of 15 million IPs with respect to any particular underlying portfolio, and that each member and member organization shall file with the exchanges a report with respect to each account in which such member or member organization has an interest, each account of a partner, officer, director or employee of the member organization, and each customer account, which has established an aggregate position of 200,000 IPs (whether long or short) covering the same underlying portfolio. These rules are designed, in part, to limit the ability of IP traders to manipulate or disrupt the market for IPs or the underlying securities and to provide the exchanges and the Commission with empirical data concerning the development of the IP market. In addition, such limits should help protect OCC from unacceptable risk. An IP position at the maximum level would have a current market value of approximately \$390 million, less than for stock index options (\$625 million). The Commission believes that fixed

maximum position and exercise limits of 15 million IPs and the proposed 200,000 aggregate position reporting requirement of IPs are sufficient to achieve their intended purposes.

The exchanges propose to halt or suspend trading in IPs whenever the exchanges deem such action "appropriate in the interests of a fair and orderly market" and to protect investors.<sup>116</sup> This proposal is based on the assumption that accurate prices may be based only upon accurate pricing of the underlying portfolios. The Commission believes that this proposal is consistent with the Act.<sup>117</sup>

### 3. Regulation T

The initial sale of an IP, by definition, will require the seller to go short. Accordingly, it is necessary to determine

<sup>116</sup> See, e.g., Phlx Rule 1047A. A trading halt in the primary market for underlying stocks accounting for 20% or more (in the case of CBOE) or 50% or more (in the case of Amex) of the portfolio value now will be one of several factors that may be considered by the exchanges in determining whether to halt trading in the IP.

<sup>117</sup> The recent Commission approval of proposed rule changes submitted by the NYSE, Phlx, Amex, and CBOE to halt trading on the exchanges for one hour if the Dow Jones Industrial Average ("DJIA") declines 250 or more points from its previous day's close and an additional two hours if the DJIA declines 400 points from its previous day's close ("circuit breaker" proposals) would be applicable to IPs. In this regard, the Phlx circuit breaker proposal does not alter existing Exchange trading halt and suspension rules. See Securities Exchange Act Release No. 26386 (December 22, 1988), 53 FR 52904. Thus, when the circuit breaker is activated Phlx Rule 1047A, which applies to CIP trading, will cause trading in CIPs to be halted because more than 20% of the value of the underlying security is not trading. In addition, the Amex circuit breaker proposal provides that all securities will halt trading on the exchange when the predetermined limits are reached. See Securities Exchange Act Release No. 26198 (October 19, 1988), 53 FR 41637. Because the Amex proposed EIP rule change defines the instrument as a security, EIPs will halt trading when the circuit breaker is activated. Moreover, although CBOE's circuit breaker proposal provides for the cessation of trading in stock options and stock index options when the predetermined limits are reached, the proposed CBOE VIP rules provide that VIP's will halt trading when 20% of the value of the underlying security is not trading. Thus, when the circuit breaker proposal halts trading on the Exchange VIPs also will cease trading.

<sup>114</sup> See, e.g., Phlx Rules 1024 and 1025; Amex Rules 920 and 922.

<sup>115</sup> Nevertheless, once IPs are approved for trading, we would anticipate that the question files for both the General Securities Representative and Registered Option Principal Examinations would be updated to include questions concerning index participations.

what margin treatment for IPs is appropriate. In this regard, the Phlx, CBOE, and Amex requested an interpretation from the FRB<sup>118</sup> that IPs be treated as equity securities rather than securities options under the relevant provisions of Regulation T.<sup>119</sup> The FRB's staff has issued a letter not objecting to the commencement of IPs trading employing the proposed initial (50% margin for IP purchases and 150% margin for IP shorts) and maintenance (130% of the value of all short IP positions and 25% of the value of all IP long positions maintained in customer margin accounts) margin for IPS.<sup>120</sup>

#### 4. Clearance and Settlement

The exchanges propose to have IPs cleared and settled by the OCC. In this regard, on March 3, 1988, the OCC filed with the Commission a proposed rule change to enable the OCC to issue, clear, and settle index participations.<sup>121</sup> The proposal will allow the OCC to process IP transactions in accordance with procedures that are substantially similar to OCC's well-established systems and procedures.<sup>122</sup>

<sup>118</sup> See, e.g., Letters to Laura Homer, Securities Credit Officer, FRB from Richard Chase, Executive Vice President, Phlx (February 3, 1988) and from Gordon L. Nash, Senior Executive Vice President, Legal and Regulatory Affairs, Amex (March 8, 1989).

<sup>119</sup> See 12 C.F.R. §§ 220.5(c) and 220.18(a), (c), and (f) (1988).

<sup>120</sup> See Letter from Laura Homer, Securities Credit Officer, FRB, to Richard Ketchum, Director, Division of Market Regulation, SEC, dated March 20, 1989. The exchanges proposed rule changes also contemplate the use of escrow receipts as cover for IP short positions and special margin treatment for certain market strategies. Currently, the exchanges and the FRB are in the process of working out such details. Thus, amendments to the margin regulations may be necessary.

<sup>121</sup> See Securities Exchange Act Release No. 25529 (March 29, 1988), 53 FR 10960.

<sup>122</sup> The Commission approved the OCC's proposed rule change to issue, clear, and settle IPs simultaneously with the exchanges' proposed rule changes to list and trade IPs. See Securities Exchange Act Release No. 26713 (April 11, 1989).

#### V. Conclusion

Based upon the aforementioned factors the Commission finds that the proposed rule changes relating to the listing and trading of index participations are consistent with the requirements of Section 6(b)(5) and the rules and regulations thereunder.<sup>123</sup> The initiation of IPs trading, however, is conditioned upon:

- (1) issuance of an order under Rule 9b-1 approving the IPs disclosure document; and
- (2) issuance of an order approving the OCC's proposed rule change to issue, clear, and settle IPs.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>124</sup> that the proposed rule changes be, and hereby are, approved.

By the Commission.

/s/Jonathan G. Katz  
Jonathan G. Katz  
Secretary

Dated: April 11, 1989

#### Concurring Statement of Commissioner Cox

I concur in the Commission's finding that these products are securities. I also concur in the Commission's reasoning, except insofar as the order argues that the products are actually "stock" within the meaning of Section 3(a)(10). I believe an IP may reasonably be classified as a "certificate of interest

<sup>123</sup> The Commission notes that approval of the proposed rule changes is based upon a determination that the terms of the IPs contracts, at the present time, are consistent with the requirements of the Act. If the terms of the IPs contracts are changed in a material way, however, it would be necessary to publish notice of that change as an amendment to the filing in order to afford the public an opportunity to review the proposed modification and for the Commission to review its prior determination.

<sup>124</sup> 15 U.S.C. § 78s(b)(2) (1982).



or participation." Moreover, the fact that IPs share so many of the characteristics of stock and other securities products strongly suggests that Section 3(a)(10)'s residual classification for "any instrument commonly known as a 'security' " should be read to include IPs.

## APPENDIX G

### SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-26713; File No. SR-OCC-88-02).

Self-Regulatory Organizations; Options Clearing Corporation; Order Approving Proposed Rule Change Providing for the Issuance, Clearance, and Settlement of Index Participations

#### I. Introduction

On March 3, 1988, the Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change (File No. SR-OCC-88-02) under Section 19(b) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder.<sup>2</sup> The proposal would enable OCC to issue, clear, and settle a new product known as Index Participations ("IPs") whose value is determined by reference to the value of an underlying stock index. The Commission published notice of the proposal in the *Federal Register* on April 4, 1988.<sup>3</sup> OCC amended the proposed rule change on June 3, 1988,<sup>4</sup>

<sup>1</sup> 15 U.S.C. § 78s(b)(1).

<sup>2</sup> 17 C.F.R. § 240.19b-4.

<sup>3</sup> Securities Exchange Act Release No. 25529 (March 29, 1988), 53 FR 10960. As originally proposed, the rules referred to IPs as Cash Index Participations ("CIPs"). CIPs initially were proposed by, and would be listed and traded on, the Philadelphia Stock Exchange, Inc. ("Phlx"). See Securities Exchange Act Release No. 25495 (March 23, 1988), 53 FR 10311, providing notice of proposed rule change by Phlx that would enable Phlx to list and trade CIPs based on two stock market indexes.

<sup>4</sup> Securities Exchange Act Release No. 25867 (June 29, 1988), 53 FR 25560. Because the American Stock Exchange, Inc. ("Amex") proposed to list and trade Equity Index Participations ("EIPs") pursuant to rules then similar to those proposed by Phlx for CIPs [see Securities Exchange Act Release No. 25664 (May 5, 1988), 53 FR 16805], the amendment, among other things, changed the name of the product in OCC's proposed rules from CIPs to IPs so that the rules may apply generally to IPs. Subsequently, the Chicago Board Options Exchange, Inc. ("CBOE") submitted

December 19, 1988,<sup>5</sup> January 27, 1989, and March 16, 1989.<sup>6</sup> The Commission received four comment letters opposing the proposed rule change.<sup>7</sup> For the reasons discussed below, the Commission has determined to approve the proposed rule change.<sup>8</sup>

## II. Description of the Proposal

The proposal amends OCC By-Laws and Rules to provide for the issuance, clearance, and settlement of IPs. An IP is a product whose value is determined by reference to the value of an underlying stock index.<sup>9</sup> IPs were designed to

proposed rule changes to list for trading Value of Index Participations ("VIPs") [see Securities Exchange Act Release No. 25799 (June 13, 1988), 53 FR 22754].

<sup>5</sup> See Securities Exchange Act Release No. 26388 (December 22, 1988), 53 FR 52901. This amendment conforms OCC's proposed IP rules to the proposed rules, as amended, filed by the exchanges.

<sup>6</sup> Because these amendments contain no new concepts but merely modify rules previously proposed by OCC, the amendments have not been published for comment in the *Federal Register*. The amendments make OCC's proposed rules more precise and respond to various comments on the proposed rules that OCC had received.

<sup>7</sup> See letter from Thomas R. Donovan, President, Chicago Board of Trade, to Jonathan G. Katz, Secretary, SEC, dated April 26, 1988; letter from Philip L. Stern, Freeman, Freeman & Salzman, P.C., on behalf of the Chicago Mercantile Exchange ("CME"), to Jonathan G. Katz, Secretary, SEC, dated April 29, 1988; letter from Philip L. Stern, Freeman, Freeman & Salzman, P.C., on behalf of the CME, to Jonathan G. Katz, Secretary, SEC, dated August 2, 1988; and letter from Jerrold E. Salzman, Freeman, Freeman & Salzman, P.C., on behalf of the CME, to Jonathan G. Katz, Secretary, SEC, dated January 11, 1989. These commentators opposed the OCC filing for the same reasons set forth in comment letters opposing the parallel exchange rule filings. Accordingly, these comments are discussed in Securities Exchange Act Release No. 26709 (April 11, 1989), ("Exchange approval order"). See note 37, *infra*.

<sup>8</sup> The Commission also has approved the related exchange rule filings (SR-Phlx-88-07, SR-Amex-88-10, and SR-CBOE-88-09) enabling the exchanges to list and trade a variety of IP products. See Exchange approval order, *id*.

<sup>9</sup> The Phlx has designated two indexes for CIP trading: the Blue Chip Index, a price-weighted index composed of 25 highly capitalized listed

place the holder of an IP in an economic position substantially equivalent to that of a purchaser of a portfolio or basket of stocks comprising the underlying index. A holder of an IP would be entitled to receive, and the writer of an IP would be obligated to pay, a quarterly dividend equivalent. The dividend equivalent would equal the regular cash dividends accrued over the quarter which the owner of a basket of stocks described above would be entitled to receive; it would not include stock dividends or extraordinary cash dividends. An IP would exist until the holder or writer extinguishes the IP by entering into an offsetting writing or purchasing transaction, or exercises a "cash-out privilege" that is available, depending on the IP, on a daily, quarterly or semi-annual basis.

The cash-out privilege provides for a payment in cash based upon the current value of the component stocks of the underlying index at the time specified by each exchange during which the privilege is available.<sup>10</sup> For example, Phlx's proposed IP rules provide that the cash-out privilege would be available to holders of IPs on any business day. Pursuant to the proposed Phlx rules, however, exercise of the cash-out privilege would entitle an exercising holder to an "aggregate

common stock issues representing primarily industrial corporations which is designed to reflect the performance of the Dow Jones Industrial Average ("DJIA"), and the Standard & Poors 500 ("S&P" 500) Index. The Amex EIPs will be based on the Major Market Index ("XMI") and the S&P 500 Index. CBOE VIPs will be based on the capitalization-weighted CBOE 50 and CBOE 250 indexes developed and maintained by the Exchange, and the S&P 500 Index. All IPs covering the same index group and having identical contract terms constitute a "class of IPs."

<sup>10</sup> The days on which the cash-out privilege is available for IPs traded on each Exchange are stated in Interpretations added to OCC's Rules. Generally, the cash-out time for each quarterly or semi-annual period, depending on the IP, will be determined and made public by each Exchange before the beginning of such period. Amex has determined that its cash-out time will coincide with "dividend equivalent day"—the third Friday of March, June, September and December. See Rule 1903, Interpretations and Policies .02, .03 and .04.



cash-out value"<sup>11</sup> computed in a different manner depending on the day of exercise. If the CIP holder exercises on the business day before an IP dividend equivalent day, the aggregate cash-out value would be based on the opening values of the stocks in the underlying index on the IP dividend equivalent day. If the CIP holder exercises on any other business day, the aggregate cash-out value would be based on the closing index value on the business day following the exercise, reduced by one-half of one percent.

For CBOE VIPs, each writer as well as each holder would be entitled to a cash-out privilege on a semi-annual basis. These IPs therefore are referred to in OCC's proposed rules as "two-way IPs." The writer's cash-out privilege would entitle the writer to extinguish the short position and pay the cash-out value. Holders of two-way IPs would have a corresponding obligation, upon assignment of a writer's exercise notice, to extinguish long IP positions in exchange for payment of the cash-out value.

On the Amex, EIP holders would be entitled to exercise either the cash-out privilege or a delivery privilege on a quarterly basis. EIP holders could receive either the cash-out value or, under certain circumstances, physical delivery of shares of the component stocks of the S&P 500 Index or the Major Market Index. EIPs for which the delivery privilege has been exercised are referred to as "physical IPs" in OCC Rules. Specifically, the holder of one or more delivery units<sup>12</sup>

<sup>11</sup> Aggregate cash-out value is equal to the settlement index value times the index multiplier times the minimum trading unit. The Exchanges have determined that the minimum unit of trading in IPs shall be 100 IPs, unless otherwise designated by the Exchange. OCC By-Laws, Article XVIII, Section 1.

<sup>12</sup> The term "delivery unit" regarding any class of physical IPs means the unit, consisting of the minimum number of trading units of such IPs specified by the Exchange, for which the delivery privilege may be exercised. The Amex has established the delivery unit as 500 minimum trading units for the S&P 500 Index and 250 minimum trading units for the XMI. OCC By-Laws, Article XVIII, Section 1. See Securities Exchange Act

that has not chosen to exercise the cash-out privilege has the right to obtain on each delivery time, which coincides with the quarterly cash-out time, the physical delivery of a proportionate number of shares of each stock comprising the underlying index, subject to certain conditions. A delivery fee established by the Amex would be charged to the EIP holder taking physical delivery of the component stocks.

Exercise notices requesting physical delivery of one or more delivery units will be assigned first, on a random basis, to those short EIP positions that have notified OCC of a desire to make physical delivery ("physical assignment volunteers"). If the number of delivery units for which holders have requested physical delivery exceeds the number of units made available for delivery by persons with short EIP positions, an Amex-designated "delivery facilitator" would assume responsibility for delivering the physical shares for such excess number of units.<sup>13</sup>

In proposing rules that would provide for the issuance, clearance, and settlement of IPs, OCC has, where appropriate, paralleled its existing rules and procedures. The proposal consists of a new Chapter XIX to OCC Rules applicable to IPs; amendments to Chapter VI dealing with margin; amendments to Chapter X to provide for a clearing fund contribution for IPs; revisions to the close-out provisions in Chapter XI; and conforming changes to Rules 207, 401 and 402 dealing with records and trade reporting. In addition, the proposal amends a number of OCC By-Laws and adds a new Article XVIII dealing exclusively with IPs.

Release Nos. 26243 (November 2, 1988), 53 FR 45407, and 26355 (December 13, 1988), 53 FR 51181, for a detailed discussion of the physical delivery aspect of Amex's proposal.

<sup>13</sup> The delivery facilitator would be an OCC clearing member that is a member organization of the exchange. OCC By-Laws, Article XVIII, Section I. Initially, the Amex contemplates designating only one facilitator per EIP class and notes that the facilitator may be the specialist unit for that class of EIPs. See Securities Exchange Act Release No. 26355 (December 13, 1988), 53 FR 51181.

### A. Processing of IPs

OCC would process IP transactions in accordance with procedures that are substantially similar to OCC's well-established system for processing equity and non-equity option ("NEO") transactions. As discussed in more detail below, OCC would receive compared trade data from the exchanges, issue and (in the case of closing transactions) cancel the appropriate contracts. OCC would make appropriate book entries to clearing members' accounts representing the long and short positions in each account.<sup>14</sup> IP transactions would settle through OCC's existing systems on a next-day basis in same-day funds.<sup>15</sup> OCC would collect margin on short IP positions. As discussed below, CIPs, VIPs, and certain EIPs are cash-settled. Therefore, OCC would process exercises and assignments according to procedures similar to those for NEO securities. On the other hand, certain EIPs provide the holder the right to physical delivery of the securities that comprise the index. Settlement of exercises and assignments regarding these physical IPs would be effected through designated stock clearing corporations.

For example, OCC's proposed system for processing exercises and assignments of the IP cash-out privilege generally parallels the system for processing exercises and assignments of NEO and equity securities. Specifically, clearing members exercising the cash-out privilege would tender exercise notices to OCC between 10:00 a.m. and 8:00 p.m. (Eastern Time)<sup>16</sup> on any day such exercises are permitted. In accordance with its existing procedures, OCC would accept all properly tendered exercise notices on the date of tender ("T") and would assign, pursuant to its procedures for ran-

<sup>14</sup> IPs would be uncertificated securities.

<sup>15</sup> The proposed IP rules provide that OCC reserves the right to pay clearing members by issuance of an uncertified check for the net settlement amount.

<sup>16</sup> All times referred to herein are Eastern Time.

dom selection,<sup>17</sup> exercise notices in connection with the cash-out privilege submitted by exercising IP holders (or writers, in the case of two-way IPs) to clearing members with short positions (or long positions, in the case of two-way IPs) in that class of IP.

OCC would calculate the aggregate cash-out value<sup>18</sup> for each class of IPs on T+2 ("exercise settlement date") and would net the exercise settlement amounts to be paid by the clearing member against the exercise settlement amounts to be paid to the clearing member to obtain a single net settlement amount for IP exercises and assignments for each account of each clearing member. Prior to 8:00 a.m. on exercise settlement date, OCC would issue a report to clearing members advising them of their cash delivery and receive obligations. OCC would be authorized to draft clearing members' bank accounts at or before 10:00 a.m., and would be obligated to credit clearing members' bank accounts at or before 11:00 a.m., as appropriate, in satisfaction of net settlement amounts.

With respect to a feature of Amex EIPs, however, a holder could exercise the delivery privilege, instead of the cash-out privilege, by tendering an exercise notice to OCC between 10:00 a.m. and 8:00 p.m. on any day such exercises are permitted. Additionally, an EIP writing clearing member desiring to become, or acting on behalf of an EIP writer that desires to become, a physical assignment volunteer would tender to OCC a physical assignment volunteer notice be-

<sup>17</sup> See Securities Exchange Act Release No. 21899 (March 27, 1985), 50 FR 13444, approving OCC's revised random assignment procedures.

<sup>18</sup> Aggregate cash-out value is equal to the settlement index value (based on the opening trades of the index's component stocks on T+1) as reported by the exchange or the reporting service designated by the exchange, times the index multiplier times the minimum trading unit. If the settlement index value is not reported to OCC in a timely manner, OCC would be authorized to suspend settlement regarding that class of IPs and to fix a new exercise settlement date. The settlement index value as initially reported would be presumed to be accurate and would be final for purposes of calculating the aggregate cash-out value.



tween 10:00 a.m. and 8:00 p.m. on any day on which exercises are permitted regarding such IPs. Again, OCC would accept all properly tendered exercise notices and would accept properly tendered physical assignment volunteer notices to the extent they equal or are exceeded by the number of delivery units to which physical delivery exercise notices have been accepted by OCC. If the number of delivery units for which physical assignment volunteer notices were submitted was smaller than the number of physical delivery exercise notices tendered to OCC, OCC would randomly assign a sufficient number of exercise notices in connection with the delivery privilege to non-volunteering physical IP writers to make up the imbalance. These writers would be required to pay to OCC the aggregate cash-out value on T + 2. OCC then would notify the delivery facilitator,<sup>19</sup> before the opening of trading on the next business day, of the amount of the imbalance and it would buy the necessary shares to make up the baskets of deliverable stock in the opening transactions on the relevant markets.<sup>20</sup>

Delivery privilege exercises and assignment of delivery privilege exercises to physical assignment volunteers would be settled through the facilities of designated clearing corporations. Following the close of trading on the business day following the day on which delivery privilege exercise notices have been accepted by OCC, OCC would report the net amount of deliverable stock to be received or delivered to the designated clearing corporation of each clearing member. Clearing members making delivery would pay to OCC, and

<sup>19</sup> In the event that the agreement of a delivery facilitator to act as such, or the delivery facilitator's status as an OCC clearing member is terminated or suspended prior to the opening of trading on the trading day following the day on which an IP is exercised for delivery of stock, OCC would have the right to pay the cash-out value in lieu of stock to the extent that the exercise was assigned to the delivery facilitator rather than a volunteer writer.

<sup>20</sup> The delivery facilitator would buy at the opening because the aggregate cash-out value paid by non-volunteering physical IP writers would be based on the value of the underlying index calculated using opening values.

OCC would pay to the clearing member entitled to receive delivery, the entire "aggregate delivery value"<sup>21</sup> of each delivery unit on the morning of the sixth business day following the day on which a delivery privilege exercise notice is properly tendered to OCC ("T + 6" or "exercise settlement date"). Under this method, each clearing member entitled to receive delivery would then pay its designated clearing corporation the appropriate price for each component stock on T + 6.<sup>22</sup>

OCC has designed a new rule to deal with a feature unique to IPs—the dividend equivalent. Proposed Rule 1902 provides that the exchange notify OCC on each day prior to an IP dividend equivalent day the amount of the dividend equivalent to be received by IP holders and paid by IP writers on dividend equivalent day. The amount of the dividend equivalent is determined by the exchange on which the IP is traded based upon the regular cash dividends paid on stocks comprising the underlying index through the quarterly period. OCC, in turn, would notify clearing members prior to 8:00 a.m. on dividend equivalent day of their obligation to pay to OCC or to receive from OCC the net IP dividend equivalent.<sup>23</sup> The procedures for payments of dividend equivalents would conform to other settlement procedure provisions in OCC Rules, as discussed above.

<sup>21</sup> Aggregate delivery value regarding a delivery unit of IPs refers to the value of such delivery unit, equal to the aggregate cash-out value times the delivery unit.

<sup>22</sup> Settlement at stock clearing corporations generally is by payment of certified check in clearinghouse (i.e. next-day) funds.

<sup>23</sup> OCC would be obligated to pay clearing members that are entitled to dividend-equivalents even if OCC does not receive a payment from a clearing member that owes OCC dividend equivalents. OCC would use the defaulting clearing member's margin deposits and clearing fund contribution to pay the amount of the dividend equivalent to the clearing member entitled to receive it. If a defaulting clearing member's margin deposit and clearing fund contribution are inadequate, OCC would assess pro rata all clearing members' clearing fund contributions to the NEO clearing fund.

### B. Margin

As the issuer of IPs, OCC guarantees the performance of clearing member IP writers and holders. To collateralize this guarantee in the event a clearing member defaults, OCC requires writing clearing members to, among other things, deposit margin with OCC.<sup>24</sup>

OCC generally would calculate clearing member margin requirements for short IP positions in a manner similar to that used for OCC's NEO margin system.<sup>25</sup> The NEO margin system has two components—premium margin, which can be a requirement or a credit, and additional margin. The term “premium margin” used in respect of IPs means the number of minimum trading units times the current highest asked price (or, in the case of exercised or assigned IP positions, times the aggregate current index value). “Additional margin” is calculated by determining assumed maximum one-day price movements in the underlying assets and projecting the effect of such movements on the liquidating value of the position on the basis of options pricing models.

Because IPs do not have an exercise price or expiration date, the “series” concept for option contracts would not apply. OCC would not differentiate among IPs based on the same underlying index, and a class group, *i.e.*, IPs based on the same underlying index, would include only one class of IPs. The proposal also would extend the product group concept to IPs, so that a class group consisting of a class of IPs may be margined on a combined basis with other class groups

<sup>24</sup> OCC's margin requirements apply only to OCC clearing members and should not be confused with the minimum margin that must be maintained in customer accounts as set by the exchanges in accordance with Regulation T of the Federal Reserve Board (“FRB”).

<sup>25</sup> OCC's NEO margin system employs a portfolio evaluation methodology using options price theory to project the cost of liquidating a portfolio of positions in the event of an assumed “worst case” change in the price of the underlying interests. See Securities Exchange Act Release No. 23167 (April 22, 1986), 51 FR 16127, in which the Commission approved OCC's NEO margin system.

of IPs or index options, where OCC has determined that their respective underlying indexes exhibit sufficient price correlation to warrant such margin treatment. For example, a class group consisting of the XMI EIP could be combined with a class group consisting of the S&P 500 EIP, CIP and VIP for margin calculations because they both belong to the broad-based indexes product group.<sup>26</sup> Moreover, these class groups could be combined with index options such as the XMI option traded on the Amex, and the S&P 100 and S&P 500 Index options traded on the CBOE, because these, too, belong to the broad-based indexes product group.<sup>27</sup>

When writers assigned exercises of the cash-out privilege pay OCC the aggregate cash-out value on exercise settlement date on T+2, OCC would release margin held in respect of those positions. OCC would continue to require margin from clearing members with the obligation to deliver stock until exercise settlement day for physical delivery on T+6. The delivery facilitator, however, would be required only to post additional margin (*i.e.*, margin to cover OCC's exposure to an adverse market move during the day on which it was required to buy deliverable stock), and not premium margin because the assigned writers would be obligated to OCC for that amount, and that obligation would be secured by the margin deposits of those writers.<sup>28</sup> Because IPs would be margined under OCC's NEO margin system, the proposal

<sup>26</sup> A haircut would be applied to additional margin credits to account for the lack of perfect correlation between class groups.

<sup>27</sup> OCC would not provide margin credit for unsegregated long physical IP positions in a clearing member's customer's account as to which the delivery privilege has been exercised, on and after the second business day after tender of the exercise notice, because OCC would not be able to control the long value of the position on and after that day.

<sup>28</sup> In effect, the delivery facilitator would receive a margin credit equal to the sum of the aggregate cash-out values paid to OCC in connection with assignments of physical delivery exercises, because OCC would be holding that amount pending settlement with the delivery facilitator on exercise settlement day.



provides that each clearing member's contribution to the NEO clearing fund would be calculated on the basis of margin requirements for IPs as well as NEOs.<sup>29</sup>

The proposal also would extend OCC's Pledge Program to IPs thereby allowing clearing members to obtain financing by pledging long IPs as collateral to support loans from banks or other clearing members. Additionally, IPs would be eligible to be pledged from segregated (customer) accounts. In this regard, Phlx and Amex requested an interpretation from the FRB<sup>30</sup> that IPs be treated as equity securities for purposes of the relevant provisions of Regulation T.<sup>31</sup> Thus, the exchanges proposed that IPs be margined like common stock.<sup>32</sup> Accordingly, the FRB staff issued a letter not objecting to the commencement of IPs trading employing the proposed initial and maintenance margin for IPs.<sup>33</sup> Therefore, long IP positions in a customer account that constitute customer margin securities would be able to be pledged to secure obligations of the carrying broker to the same extent as common stock.<sup>34</sup> Amendment No. 3 makes explicit that IPs could be transferred into and out of pledge accounts only in multiples of minimum trading units.

### *C. Suspension of an IP Clearing Member*

The proposal would amend existing OCC Rules dealing with suspension of a clearing member to incorporate refer-

<sup>29</sup> Delivery facilitators would not be required to contribute to OCC's NEO clearing fund on account of their facilitating activities unless they otherwise carry IP or NEO positions.

<sup>30</sup> See letters to Laura Homer, Securities Credit Officer, FRB, from Richard T. Chase, Executive Vice President, Phlx, dated February 3, 1988, and from Gordon L. Nash, Senior Executive Vice President, Legal and Regulatory Affairs, Amex, dated March 8, 1989.

<sup>31</sup> See 12 C.F.R. §§ 220.5(c) and 220.18(a), (c), and (f) (1988).

<sup>32</sup> See Exchange approval order at 65-66.

<sup>33</sup> See letter from Laura Homer, Securities Credit Officer, FRB, to Richard Ketchum, Director, Division of Market Regulation, SEC, dated March 20, 1989.

<sup>34</sup> OCC's proposed rules require the clearing member to represent that all IPs pledged from customer accounts constitute margin securities. See OCC Rule 611.

ences to IPs. Because failure to pay a dividend equivalent or to meet settlement obligations with respect to IPs is necessarily a failure to meet a daily money obligation to OCC, OCC's proposed rules would provide for the application of its existing suspension rules and the disposition of settlement obligations through the Liquidating Settlement Account.<sup>35</sup> OCC would close out short IP positions<sup>36</sup> of a suspended clearing member, like uncovered short option positions, in the most orderly manner practicable. Any dividend equivalents that may be owed regarding short IP positions of a suspended clearing member would be withdrawn from the Liquidating Settlement Account. Proposed rule 1908 expressly would state that the suspension of a clearing member in the course of cash-out privilege exercise settlement would not affect the settlement procedures applicable to other clearing members.

Proposed Rule 1908 would provide close-out procedures in the event a clearing member that is obligated to deliver stock fails to perform, or a clearing member that is entitled to receive deliverable stock is suspended before its designated clearing corporation becomes obligated to make settlement for the deliverable stock. In the former case, OCC would direct clearing members entitled to receive deliverable stock, *i.e.*, the clearing member matched against the non-performing clearing member in the stock trades reported to the stock clearing corporations, to buy in the stock for the account and

<sup>35</sup> See OCC Rule 1104. The Liquidating Settlement Account is a special account created upon the suspension of an OCC clearing member. The account consists of the suspended clearing member's assets on deposit with OCC, including margin deposits, securities held in bulk, and that member's OCC clearing fund contributions. OCC closes out a suspended clearing member's outstanding obligations to OCC through transactions in this account.

<sup>36</sup> Currently, there are no "covered short IP positions" and the provisions of the rules that address these positions would have no effect. OCC has filed a separate rule change that would set out the requirements for IP escrow receipts. See Securities Exchange Act Release No. 26435 (January 10, 1989), 54 FR 1832. The Commission currently is reviewing this proposal.

liability of OCC, and settle the buy-in as quickly as possible after it occurred. In the latter case, OCC would direct delivering clearing members to sell out the deliverable stock and pay the proceeds of the sale to OCC.

The proposal also would amend OCC's By-Laws. Among other things, a new Article dealing with IPs provides definitions applicable to IPs, most of which parallel the definitions used regarding index options. The proposed Article also would set out the general rights and obligations of IP holders and writers. Additionally, in this Article OCC would reserve the right, on 30 days' notice, to exercise the cash-out privilege on behalf of all holders of a class of IPs, and thereby close out the market in that class, under certain extraordinary circumstances, *e.g.*, when there is a lack of regular trading activity in such class.

The proposal also would amend various OCC By-Laws to accommodate IPs. Among these changes, Article I would define "cleared security" to include IPs and would clarify that the terms "exercise" and "Exercising Clearing Member" can refer to exercise of the cash-out privilege in connection with IP transactions.

### III. OCC's Rationale for the Proposed Rule Change

OCC believes the proposed rule change is consistent with the purposes and requirements of Section 17A of the Act because it would provide for the prompt and accurate clearance and settlement of transactions in IPs. OCC states in its filing that the proposed rule applies to IPs rules and procedures substantially similar to those that have been used in the clearance and settlement of transactions in equity and non-equity options. Moreover, OCC believes that the proposed rule change provides for the safeguarding of securities and funds in OCC's custody or control or for which OCC is responsible, in that it would apply to IPs a system of safeguards which is substantially the same as the system OCC currently uses for options.

### IV. Discussion

For the reasons discussed below, the Commission is approving OCC's proposal. The Commission believes that OCC's proposal is consistent with Section 17A of the Act and OCC's obligation to promote the prompt and accurate clearance and settlement of securities transactions and to safeguard securities and funds in OCC's custody and control.<sup>37</sup>

Since the October 1987 market-break, a number of studies have recommended creating a market basket product.<sup>38</sup> These studies suggest that such a product could, among other things, ameliorate the volatility and steep price declines experienced during and since October 1987. These studies also focus on clearance and settlement of equities, options and futures, and the need to develop safe and efficient clearance and settlement systems both within and between markets. The latter focus is the subject of this filing and order.<sup>39</sup>

The Commission is satisfied that the proposed system for processing IP transactions is substantially similar to OCC's well-established system for processing NEO transactions. The Commission believes that use of that system is well designed to promote the prompt and accurate clearance and settlement of transactions in IPs consistent with Section 17A(b)(3) of the Act. With certain exceptions for physical IPs and IP dividend equivalent payments that will be discussed

<sup>37</sup> Several commentators expressed the belief that IPs are stock index futures, not securities. That issue is discussed in detail in the order approving the exchanges' proposal to trade IPs and, therefore, is not addressed in this order. This order incorporates the exchanges' approval order rationale for concluding that IPs are securities. See note 7, *supra*.

<sup>38</sup> See, *e.g.*, N. Katzenbach, *An Overview of Program Trading and Its Impact on Current Market Practices* (December 21, 1987) and Division of Market Regulation, *The October 1987 Market Break* (February 1988) ("Staff Report"). See also Report of the Presidential Task Force on Market Mechanisms (January 1988) and the Interim Report of the Working Group on Financial Markets (May 1988) ("Working Group Report") for other recommendations arising out of the October 1987 market break.

<sup>39</sup> See Exchange approval order, *supra*, note 7, for a discussion of the benefits of a market basket product.



below (as well as the characteristics pertaining to the potential perpetual existence of IPs), the proposed system is identical to OCC's system for processing NEO transactions. For example, exchanges will use existing systems to report opening and closing trades in IPs to OCC. Additionally, OCC will maintain records and process opening and closing transactions,<sup>40</sup> will process exercise notices in connection with the cash-out privilege, and will assign those exercises to OCC clearing members with IP positions on the other side of the market in accordance with existing procedures. Finally, OCC will effect net settlement each day with its clearing members for all IP and option transactions, including amounts owed in connection with dividend equivalents, pursuant to its well-established settlement procedures.

At least one market break report<sup>41</sup> noted that efforts to monitor clearing firm risk more effectively are critical to reducing risk and increasing confidence in the markets. In connection with this, the report emphasized the need for market participants to have access on a timely basis to information concerning the specific size and nature of their payment obligations so that they can make appropriate arrangements to fulfill them. In this regard, the Commission is concerned that clearing members know their IP dividend equivalent payment obligation in sufficient time to collect the payment from their customers or to arrange financing to meet that obligation. The Commission notes that although many of the indexes underlying IPs are well-established and widely disseminated, there are no arrangements for separately quoting the value of the dividend equivalent at this time. The Commission recognizes that the formulas for calculating the different index values will be set out in exchange rules and, therefore, a clearing

<sup>40</sup> Unlike NEOs where OCC collects the premium from IP purchasers and requires writers to post as margin the premium plus an additional margin amount, OCC would collect from IP purchasers the aggregate index value and IP writers would be required to post (in the form of cash or other adequate collateral) the highest asked price or, for exercised or assigned IPs, the aggregate index value, plus an additional margin amount.

<sup>41</sup> See Working Group Report, *supra*, note 37.

member could compute the amount due with respect to each IP trading unit from published reports of dividends paid before dividend equivalent day. Nevertheless, the Commission urges OCC, in the months after IP trading commences, to monitor the ability of clearing members to meet their dividend equivalent obligations and to discuss with clearing members and the exchanges whether there is a need for earlier dissemination of IP dividend equivalent values.<sup>42</sup>

The Commission agrees with OCC that it is appropriate to include IPs in OCC's existing NEO margin system for OCC clearing members. Like NEOs, IPs generally are cash-settled.<sup>43</sup> In approving the NEO margin system,<sup>44</sup> the Commission determined that it provided a refined methodology for calculating margin, resulting in increased protection to OCC against adverse price movements in underlying assets. Additionally, recognizing that no margin system is designed to protect against the most extreme market moves, the Staff Report issued in connection with the October market break generally concluded that OCC's NEO margin system is a reliable method of risk measurement. Nevertheless, the Commission expects OCC to review and reassess periodically the NEO margin system and to make modifications, where appropriate, to deal safely with more volatile markets.<sup>45</sup>

The proposal also extends OCC's Pledge Program to proprietary and market maker IP positions. Thus, clearing

<sup>42</sup> Based on experience regarding the actual settlement of IP dividend equivalent obligations, the Commission will review whether the exchanges should make available, on a routine basis, information regarding estimated or accrued dividend equivalents.

<sup>43</sup> Physical IPs, which are settled by delivery of the component stocks in the underlying index, are discussed below.

<sup>44</sup> See, *supra*, note 25.

<sup>45</sup> OCC recently completed a review of its margin system. See OCC, *The Backup System: A Special Study by the Margin Committee Subcommittee* (August 31, 1988). The subcommittee's report contains a number of recommendations concerning OCC's margin policies and practices. The Commission understands that OCC's Board of Directors is considering those recommendations and will implement many in the near future.

members will be able to pledge IP positions maintained in proprietary and market maker accounts to lenders.<sup>46</sup> Additionally, because the FRB has determined that IPs may be treated as margin securities under Regulation T, the proposal would extend OCC's Pledge Program to IP positions in customer accounts.<sup>47</sup> The Commission supports this extension of the Pledge Program because it provides clearing members the ability to obtain additional financing through the pledge of customer IP positions maintained in margin accounts. Moreover, the Commission believes that use of OCC facilities to conduct this pledge activity should provide greater certainty to banks financing clearing member, broker-dealer, and customer IP positions.

The Commission notes that, unlike OCC rules dealing with NEOs, the proposed IP rules provide OCC the authority to exercise the cash-out privilege for an entire class of IPs on thirty days' notice to IP holders and writers in certain limited, extraordinary circumstances. For example, such circumstances would include, but are not limited to, a lack of regular trading activity in a class of IPs or the impending termination of business on the part of OCC or the exchange on which that class of IPs is traded. The Commission agrees with OCC that it should have the ability to terminate a class of IPs under extraordinary circumstances because, unlike options which expire at a pre-established time, IPs are of unlimited duration. The Commission recognizes that in certain circumstances OCC may want to act expeditiously to close out a class of IPs. Nevertheless, the Commission notes that OCC's By-Laws authorize OCC to exercise the cash-out privilege on a *minimum* of thirty days' notice. The Commission be-

<sup>46</sup> OCC's Pledge Program is a convenient mechanism for processing pledge loans to clearing members because OCC will recognize the pledgee's interest in pledge positions. See Securities Exchange Act Release Nos. 24171 (March 4, 1987), 52 FR 7724; 22278 (July 30, 1985), 50 FR 31804; 20994 (May 25, 1984), 49 FR 23132; and 19956 (July 19, 1983), 48 FR 33956.

<sup>47</sup> Long option positions, although they can be paired with short options to reduce margin requirements, currently have no loan value for purposes of Regulation T.

lieves this period provides sufficient notice to allow market participants to make any needed adjustments to other related securities or futures positions. Nevertheless, given the extraordinary nature of a mandatory cash-out, the Commission expects OCC to make every effort to provide more than thirty days' notice where possible.

The Amex EIP provides holders exercising the delivery privilege the ability to obtain the basket of securities underlying either the XMI or the S&P 500 Index, thus creating a mechanism for the delivery of a standardized portfolio of equity securities. An EIP holder exercising the delivery privilege could obtain shares in as many as 500 companies. To otherwise establish such a portfolio would require the purchase of 500 different securities.

OCC will process exercises of the delivery privilege in a manner similar to that used for individual equity options with some modifications to reflect the unique characteristics of EIPs. For example, OCC will report EIP matched trade information to the designated clearing corporation reflecting the right of the exercising clearing member to receive shares in each of the component stocks underlying the EIP index and the obligation of either the delivery facilitator or a volunteering writing clearing member, as contra party to the exercising clearing member, to deliver an equal amount of shares in each of the component stocks. Because matched EIP trades will be processed in the designated clearing corporation's continuous net settlement ("CNS") system,<sup>48</sup> the designated clearing corporation will step between the exercising clearing member and the contra party and, in place of OCC, will guarantee those deliveries. Thus, clearing members will be able to net deliver and receive obligations in connection with

<sup>48</sup> CNS uses the system price (usually the previous days' reported closing price) to price members' payment obligations. Delivery and receive obligations are adjusted on a daily basis by a mark-to-the-market. Thus, by paying a mark-to-the-market, a clearing member with a right to receive can use that long position to offset a delivery obligation that will arise tomorrow. In CNS, every right to receive carries the obligation to pay, and every obligation to deliver carries the right to receive the system price.



physical EIP exercises with other activity in the underlying component stocks. Nevertheless, because the designated clearing corporations' CNS systems require clearing members to pay market value for securities delivered to them and pays to delivering clearing members the market value of securities they deliver (in satisfaction of their CNS delivery obligations), OCC must provide funds to the clearing member who will receive securities from the designated clearing corporation (*i.e.*, the exercising clearing member) so that the exercising clearing member can pay the designated clearing corporation and the designated clearing corporation can pay the delivering clearing member (*i.e.*, either the delivery facilitator or a volunteering EIP writer). Because the clearing member exercising the EIP physical delivery privilege previously paid the full value of the index for the right to receive the components stocks, OCC and the designated clearing corporations have converted a free delivery obligation into a delivery against payment or receipt against payment obligation.

The Commission believes it is appropriate to settle exercises of physical EIPs in this manner because it is consistent with one-account settlement.<sup>49</sup> The conversion of a free delivery obligation into a delivery against payment obligation, however, raises two concerns about cash flows. The proposed process for settling EIP delivery privilege exercises requires coordinated funds flow among many parties. The Commission notes that, in such a system, there is a risk of default by persons holding funds pending completion of the delivery process.<sup>50</sup> The Commission acknowledges OCC's

<sup>49</sup> Section 17A requires the Commission to facilitate the development of a national clearance and settlement system. One feature of such a system is one-account settlement, *i.e.*, the ability to clear and settle through one entity all securities trades, regardless of the location of the other party to the trade or the market in which the trade is executed.

<sup>50</sup> For example, generally only broker-dealers hold memberships in OCC and designated clearing corporations, *e.g.*, National Securities Clearing Corporation ("NSCC"). Therefore, a large institution that maintains

representations<sup>51</sup> that discussions are underway with the designated clearing corporations to develop a more simple process for settling exercises of physical EIPs. Nevertheless, the Commission believes it is imperative, within the months after IP trading commences, for OCC and the designated clearing corporations to design a system through which OCC can pay directly to the designated clearing corporation cash that would otherwise be paid to the exercising clearing member (perhaps using the margin deposits posted by the assigned EIP holders) on behalf of the exercising clearing member, which would entitle the exercising clearing member to receive securities, subject to daily marks-to-the-market, without payment on delivery.<sup>52</sup>

On the basis of the foregoing, the Commission finds that OCC's proposed rule change is consistent with the Act and, in particular, with Section 17A of the Act.

EIP positions must rely on the creditworthiness of a broker-dealer in converting its EIP positions to a portfolio of the underlying securities. If the broker-dealer clearing member fails while processing EIP exercises on behalf of the institutional customer and losses exceed Securities Investor Protection Corporation ("SIPC") insurance limits, that institution may suffer financial loss. Instead of having an identifiable interest in the underlying securities or the EIPs, the institution may share pro rata with all other customers in the pool of customer property maintained by the broker-dealer.

<sup>51</sup> Telephone conversation between Judith Poppalardo, Attorney, SEC, and James R. McDaniel, Schiff Hardin & Waite, on February 3, 1989.

<sup>52</sup> Such a system exists today at at least one designated clearing corporation albeit for different purposes. See Securities Exchange Act Release No. 25107 (October 1, 1987), 52 FR 43959 (approving a recent NSCC rule change that would allow an NSCC-Depository Trust Company ("DTC") member to instruct NSCC to charge the member's settlement account for 130% of the value of securities the member anticipated borrowing, but, in fact, did not receive. NSCC would segregate these funds in a fully paid-for account. This protects an NSCC-DTC member who makes a security delivery in anticipation of borrowing stock from being out of compliance with Rule 15c3-3 under the Act [the customer protection rule], if the stock is not borrowed).

Accordingly, IT IS THEREFORE ORDERED, under Section 19(b)(2) of the Act, that the proposal (File No. SR-OCC-88-02) be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.

Jonathan G. Katz  
Secretary

Dated: April 11, 1989

## APPENDIX H

### SECURITIES AND EXCHANGE COMMISSION EXCERPTS FROM TRANSCRIPT OF OPEN MEETING MARCH 14, 1989

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#### PRESENT:

DAVID S. RUDER, Chairman  
CHARLES C. COX, Commissioner  
EDWARD H. FLEISCHMAN, Commissioner  
JOSEPH A. GRUNDFEST, Commissioner  
MARY L. SCHAPIRO, Commissioner  
RICK KETCHUM, Director of Market Regulation

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#### PROCEEDINGS

CHAIRMAN RUDER: Good morning. This is a meeting of the Securities and Exchange Commission on Tuesday, March 14, 1989, under the Sunshine Act.

Our first item is proposed rule changes by three securities exchanges relating to the listing of trading of index participation.

. . .

COMMISSIONER COX: Yes, Thank you, Mr. Chairman. I guess I have three general kinds of comments — or three areas of comment here.

It seems that the first issue is whether the proposed rule changes by the exchanges are appropriate for approval by the Commission. And as Director Ketchum pointed out, they seem consistent with the '34 Act. And aside from that, I don't see investor protection concerns that will cause any problem.



One question I have about the products that are proposed—and obviously the test of the market will be the determining factor on whether they're successful or not—but they're certainly, on a priori basis, there is nothing that would lead one to believe that there would be investor protection concerns.

I was just wondering though, are there any estimates on what kind of a premium it would take to induce the people to take a short position in these index participation products? I mean obviously, if too much of a premium were demanded, they wouldn't be successful. But I think that's what takes a market test. But are there estimates of that?

MR. KETCHUM: I'm not aware of any quantified estimates of that. Clearly you're right. I think that is one of the fundamental concerns with respect to the product.

If there is a liquid secondary market for a particular index participation, then the premium should be quite small because the ability for a short to liquidate in that market should allow them to be comfortable in taking the position even though they have no cash outright.

If the liquidity of a particular index participation is much less, then the premium could be quite large and the viability and usefulness of the product would come under question.

So I don't know what that premium will be, and indeed I suspect it may vary by the nature of the underlying market for the particular participation.

COMMISSIONER COX: Thank you. The secondary, I presume, explains the abnormally high interest in this meeting—the presence of the television camera and the large audience—and that's the area of jurisdiction. I don't think it's simply new products that have drawn the interest, but the potential for some conflict over jurisdiction.

Here, when I saw that some commentators had said that these index participation products should be regarded as futures, not securities, at first it caused me some concern. But,

on considering the arguments, I'm persuaded that these are not futures products, that these are securities.

I think that you have a very strong legal argument in the release that is very persuasive. I think if you go down the characteristics of these products, that certainly you're persuaded that they are designed as investment products for retail customers that will tend to take small positions in these kind of market basket products.

You can go through the plans for margin, the cash-out provision and so on and so forth, as you mentioned in your opening remarks. But it seemed to me that taking all of the characteristics on balance, that these index participation products seem most like a type of mutual fund, an index fund, and obviously these products are created by someone taking a short position, not by a company purchasing securities.

But I really think we have something closest to an index fund here for investors and I have no concerns over the argument that these are futures. I think that they are clearly within the area that the law sets out as securities.

Finally, the third area that also raised some concern is the argument about property rights in new products, the argument raised by the Philadelphia Stock Exchange, and where they had said that the type of approval process that's involved here discourages innovation.

Well, as the Chairman pointed out, certainly as a Commission—and I think the securities laws are not designed with the purpose of discouraging innovation—unfortunately, that may be one of the unintended effects of having the kind of regulated industry that exists. Some innovation may be discouraged by the process of public comment and approval, as we're doing today.

But I think that that's the kind of decision that is weighed, or has been weighed in setting up the securities laws, and what's involved. If you made a list of possible detriments from securities regulation, possible benefits to the exchanges involved here, to the Philadelphia Stock Exchange,

or any other, I think that you would find that the benefits outweighed the detriments.

I think that certainly more mischief would be done if we attempted to hold up some of the approvals, whether we were up front about it, and said to give a head start to the Philadelphia Stock Exchange, or whether we said more work needs to be done. I don't think we have that kind of basis, I really don't. And attempting to create one in this situation I think would be wrong.

I realize that Philadelphia believes that it would be to their advantage if the product that they claim they had been working on a long time, if they had a head start, but it's just a matter of the way the securities laws work. They don't. And so I do not agree with holding up approval of the other exchanges.

So, with those comments, whether brief or lengthy, I agree with the Division's recommendation.

Thank you.

. . .

CHAIRMAN RUDER: Thank you, Commissioner Schapiro.

We will, I guess, from this day forward begin to deal with CIPs, VIPs and EIPs, which are the cash index participation, the value index participation, and the equity index participation, giving us three more acronyms in our vast arrays of acronyms in this business.

I, too, am firmly convinced that these are securities. They do resemble most clearly a basket of securities with the various rights and attributes that Commissioner Schapiro discussed.

I don't think I need to add more. Our jurisdictional justification will appear in the release which will, we hope, be available to the public by the end of the week.

Without more, I think that we may vote of this.

Commissioner Cox, do you concur in the recommendation?

COMMISSIONER COX: I concur.

CHAIRMAN RUDER: Commissioner Grundfest?

COMMISSIONER GRUNDFEST: Concur.

CHAIRMAN RUDER: Mr. Fleischman?

COMMISSIONER FLEISCHMAN: Concur.

CHAIRMAN RUDER: Commissioner Schapiro?

COMMISSIONER SCHAPIRO: Concur.

CHAIRMAN RUDER: I concur as well. Thank you.